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OVERSIGHT ON THE CONDITION OF THE FINANCIAL SERVICES INDUSTRY

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

SECOND SESSION

ON

RESULTS OF THE AUDIT OF THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION [FSLIC], 1987, FINANCIAL STATEMENTS AND THE INCREASING FUNDS AND SAVINGS AND LOAN INDUSTRY PRESENTED BY THE INCREASING NUMBER OF INSOLVENT AND INADEQUATELY CAPITALIZED INSTITUTIONS

AND

THE REPORT OF THE BANK REGULATORS ON THE VARIETY OF DEVELOPMENTS IN RECENT YEARS THAT MAKE SATISFACTORY EARNINGS FOR THE BANKING SYSTEM MORE DIFFICULT TO ACHIEVE. HOWEVER, THE OUTLOOK FOR THE IMMEDIATE FUTURE IS CAUTIOUSLY OPTIMISTIC

MAY 19, 25, AND 26, 1988

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OVERSIGHT ON THE CONDITION OF THE FINANCIAL SERVICES INDUSTRY

THURSDAY, MAY 19, 1988

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Dixon, Sasser, Sanford, Shelby, Graham, Garn, D'Amato, Hecht, Gramm, Chafee, Bond, and Karnes.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The Chairman. The committee will come to order.

In August 1987, the President signed the Competitive Equality Banking Act. That act had been painstakingly negotiated by this committee and the House Committee on Banking. One of the major provisions of the act was the FSLIC recapitalization. The act provided $10.8 billion in new borrowing authority to permit the stricken agency to resolve the industry's problems.

While the rescue package was being designed there was substantial disagreement between the administration and the savings and loan industry as to the size of the problem facing the Bank Board.

The industry argued that $5 billion in funds would be enough. The administration asked for $15 billion. Nonaligned industry analysts said that a larger than $15 billion figure would be needed.

The $10.8 billion provided for in the act came as a result of careful congressional consideration as to the merits of the vastly different estimates presented in testimony.

Now only 7 months after signing the act reports are appearing in the press that the financial problems of the industry may be getting worse and that the CEBA rescue package may be insufficient.

The GAO has estimated the size of the FSLIC deficit has more than doubled in 1 year.

This morning we will hold hearings on the S&L industry's condition. We will try to get a better picture of the size of its problems and how much money will be required to place the industry on a sound footing.

Our witnesses are Frederick Wolf, Director of Accounting and Financial Management Division of the U.S. General Accounting Office; Bert Ely, president of Ely and Company of Alexandria, VA; William Ferguson, chief executive officer of Ferguson and Company of Irving, TX; Stuart Greenbaum, Norman Strunk distinguished professor of financial institutions from Northwestern University; and Stanley Silverberg, a special consultant to Golembe Associates in Washington, and who has shown good judgment ever since he chose to go to the University of Wisconsin. We're happy to have such a distinguished panel, especially the cleanup man.

Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator **Garn**. Thank you, Mr. Chairman.

Today begins a series of three hearings on the health of the Nation's banking and thrift industries. Clearly with 2 of our 3 days of testimony devoted to savings and loans and their regulators, the major focus of concern during this series of hearings is the thrift industry.

It is difficult to pick up a financial page of a newspaper anywhere in the country, particularly in the Southwestern United States, without reading about the challenges confronting the thrift industry and its regulator, the Federal Home Loan Bank Board [FHLBB]. There are almost as many estimates of the ultimate cost of resolving thrift problems as there are articles about it.

I recall not so long ago saying to my colleagues during the FSLIC recapitalization debate that we need about $30 billion to solve the thrift problem. As a matter of fact, in July 1986, after presenting a comprehensive banking deregulation bill, this Senator felt the problem was serious enough that I should pull all sections of that bill except recapitalization of FSLIC in the amount of $15 billion.

I was absolutely distressed and amazed at the irresponsibility of the House of Representatives at that time because you didn't have to be too bright to figure out what the problem was. It started in the early 1980's when Dick Pratt was Chairman of the Federal Home Loan Bank Board. There were more thrifts closed in the first year he was there than in any year in the history of the Federal Home Loan Bank System. I felt so concerned about it that, although I had had some rather serious surgery, I came back to the Senate in the closing days just to have a clean FSLIC recap.

The Senate passed the FSLIC recapitalization bill in October 1986, more than 1½ years ago. The House of Representatives, in what is probably the height of irresponsibility, not only would not consider that clean FSLIC recap at $15 billion, they even refused to continue the emergency sections of Garn-St Germain. So we left session in October 1986 not only not giving the Bank Board new authorities and new capital, but taking away the existing authorities that had been there since 1982. The House of Representatives was intent on adding a housing authorization bill, holding FSLIC hostage for a housing authorization bill that also did not become law.

It would have made no difference if Senator Proxmire and I had been willing to accept that housing bill. The President would not have and it would have been vetoed.

So I hope no one is too surprised today at the testimony—and as I have had a chance to glance over it, I hope no one thinks that this is some great new revelation, that we need to run around like chickens with our heads cut off panicking. There are some who felt it was a problem 2 years ago. They felt that Congress did not act appropriately at that time—that Congress acted irresponsibly, by passing nothing. Then nearly a year later, the GAO reports indicated that the problem had become much worse. We were hemorrhaging at $10 million a day rather than just $6 million a day. We had to compromise with the House of Representatives to get them up to $10.8 billion.

I relate this history so that nobody is shocked or surprised at what we're talking about today. It isn't new and I'm not trying to say I was a true prophet or anything else. I did say in the public record 1½ years ago that the problem was in the neighborhood of $30 billion. The testimony today would bear that prediction of nearly 2 years ago.

I understand that when the Federal Home Loan Bank Board's auditor, the General Accounting Office, testifies here today it will be shown by their worst case scenario that my estimate was not too far off the mark. There were those at the time who said that $5 billion was enough. Others wanted $15 billion, and so, as I said, we compromised at $10.8 billion.

Let me remind you that the law providing $10.8 billion to the Federal Savings and Loan Insurance Corporation to get the job of solving thrift problems underway is only about 9 months old. Let's not forget that the early months following passage had to be spent in developing the many regulations necessary to implement the Competitive Equity Banking Act.

Let me add that since we passed that bill, the Bank Board has raised nearly $3 billion of the $3.75 billion it was authorized to raise this year through the sale of financing corporation bonds. This also resolved some of the 40 problem institutions across the Nation. It conceived and launched the Southwest Plan for solving S&L problems in the heart of the oil patch.

So here we are today, beginning these hearings largely covering the thrift industry and what we are wanting to talk about are what solutions are available. Many want to talk about new solutions like merging the FDIC and FSLIC. Others believe that the way to go is in either the creation of a new Reconstruction Finance Corporation to house the so-called brain-dead S&L's or a taxpayer bailout of the thrift industry.

Let me remind my colleagues that before we start exploring some of these "new" proposals, we ought to give our own handiwork a reasonable amount of time to provide results. I'm not saying that we don't have serious problems in the thrift industry; as I've just indicated, we do. But after delaying a legislative proposal for almost 2 years and after rejecting bigger recapitalization schemes, we ought to give the scheme that we finally put in place a reasonable amount of time to work.

GAO says in their statement today that FSLIC has significant resources to both continue operating and resolve cases in the near term. Nine months is not a reasonable amount of time to make a judgment whether recap is working or not. I know we would all like a quick fix of the thrift problem, but prudence dictates that FSLIC move in a responsible, efficient, businesslike manner. So the focus of these hearings should not be on some brand new legislative solution whose cost would be based on yet unknown assumptions. The focus of these hearings should be on how the Bank Board and FSLIC have defined their problem and have gone about solving it since the passage of CEBA. Let's explore the facts and not the fantasies. I'll be interested in learning how estimates of the magnitude of the costs are constructed. I certainly hope the speakers today will explain in detail what their assumptions are and why their cost estimates vary. We need to know the answers to these questions.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn.

Senator Hecht.

OPENING STATEMENT OF SENATOR HECHT

Senator HECHT. Thank you, Mr. Chairman.

I'm happy to be at these hearings this morning. If all of you watched the morning news, scare tactics—"Our savings and loans are in dire trouble"—as a member of the Senate Banking Committee and having been in the banking community for 25 years before I got here, I would like to put my 2 cents in and assure the American people this is not true at all. The only problem we have right now is the politics, the political aspect of it.

I think it's not coincidental that all of these problems are in one or two localized areas. And speaking as a member of the banking community for 25 years, I think we have to go in there, we have to solve our problems, and we have to keep politics out of it. We do have a problem. It's a serious problem. But this problem is not going to be worked out by politics. It's going to be worked out by astute banking and astute savings and loan people who know what they're doing.

So my answer is, keep politics out of the FSLIC.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Shelby.

Senator SHELBY. Mr. Chairman, I have an opening statement that I'd ask unanimous consent that it be made part of the record.

The CHAIRMAN. Without objection, so ordered.

[Committee insert of Senator Shelby's opening statement:]

STATEMENT BY SENATOR RICHARD SHELBY
OVERSIGHT HEARING ON THE CONDITION OF THE THRIFT INDUSTRY
MAY 19, 1988

MR. CHAIRMAN, I COMMEND YOU FOR CALLING THIS HEARING. IT COINCIDES WELL WITH THE COMMENCEMENT OF THE SOUTHWEST PLAN, THAT IS, THE PLAN DEVISED BY THE HOME LOAN BANK BOARD TO DEAL WITH THE PROBLEMS OF THE TEXAS THRIFTS.

THIS HEARING ALSO COINCIDES WITH THE RELEASE OF THE GAO'S LATEST SUMMARY OF THE THRIFT INDUSTRY'S CONDITION. IT REVEALED NOTHING ASTONISHING; IT CONFIRMS THAT THERE ARE PROBLEMS IN THE THRIFT INDUSTRY, PROBLEMS THAT ARE A RESULT OF A DANGEROUS TREND.

ONE OF MY BIGGEST CONCERNS, WHICH HAS BEEN HIGHLIGHTED BY THE TEXAS THRIFT SITUATION, IS THAT OF SPECULATIVE REAL ESTATE INVESTMENT BY THRIFTS. WE ARE AT THE JUNCTURE OF DETERMINING NEW APPROPRIATE ACTIVITIES FOR BANKS AND I AM CONCERNED THAT THERE IS A LESSON TO BE LEARNED FROM THE THRIFT INDUSTRY.

THE FOUR TEXAS THRIFTS TO BE MERGED AS THE FIRST STEP OF THE SOUTHWEST PLAN HAVE SUFFERED THE BULK OF THEIR LOSSES FROM REAL ESTATE INVESTMENT. THIS IS NO SURPRISE; **MANY** OF THE THRIFTS' PROBLEMS ARE ATTRIBUTED TO SPECULATIVE REAL ESTATE INVESTMENT. I WOULD LIKE TO PROBE THAT PHRASE A LITTLE FURTHER. I HOPE

TODAY OUR WITNESSES WILL PROVIDE A CLEARER PICTURE OF THE SORT OF ACTIVITIES THAT WERE UNDERTAKEN BY THRIFTS.

THE STRENGTH OF FINANCIAL INSTITUTIONS IS INEXTRICABLY LINKED TO THE STRENGTH OF THE ECONOMY. THE DOWNTURN IN THE TEXAS ECONOMY IS PRIMARILY RESPONSIBLE FOR THE TEXAS THRIFT PROBLEMS. HOWEVER, THE EXTENT OF THRIFTS' ACTIONS IN REAL ESTATE DID MORE THAN LINK THRIFTS TO THE ECONOMY; THE REAL ESTATE INVESTMENT PULLED THE THRIFTS UNDER.

I HOPE TODAY OUR WITNESSES WILL PROVIDE A CLEARER PICTURE OF THE SORT OF ACTIVITIES THAT WERE UNDERTAKEN BY THRIFTS. AS CONGRESS CONTINUES TO DISCUSS WHAT REAL ESTATE ACTIVITIES MIGHT BE PERMITTED FOR BANKS, IT CERTAINLY IS NECESSARY TO DISSECT THE THRIFT PROBLEMS AND LEARN FROM THEIR MISTAKE.

I LOOK FORWARD TO THE TESTIMONY OF OUR WITNESSES.

THANK YOU.

Senator **Shelby**. That's all I have. I look forward to hearing the witnesses.

The **Chairman**. Senator Bond.

OPENING REMARKS OF SENATOR BOND

Senator **Bond**. Thank you, Mr. Chairman.

I want to again commend you for having these hearings. As others have already stated, it's very timely. We did deal with this problem in the act previously passed in this Congress. Unfortunately, we do not yet know whether and to what extent our efforts will be successful in solving the problem and to what extent additional efforts will be needed. There are those of us who voted for the $15 billion figure. Even that appears may be on the short side.

We welcome this distinguished panel of experts who will give us the information that we're going to have to have as we continue to monitor this situation, recognizing, as Senator Hecht said, that the problems of some have caused undue concern about the many and significant majority of savings and loans which are on a sound basis. We do have a responsibility to the industry and the people it serves to assure that the problems are dealt with and I expect that we will have a much better idea of the situation after we hear such a fine panel as you've assembled today.

Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Bond.

I have statements from Senators Dixon, Sanford, Heinz, and D'Amato to be inserted in the record.

MAY 19, 1988

STATEMENT OF SENATOR ALAN DIXON

SENATE BANKING COMMITTEE HEARING
ON
THE STATE OF THE THRIFT INDUSTRY

MR. CHAIRMAN, AS THIS MORNING'S WITNESSES WILL POINT OUT, THE SAVINGS AND LOAN INDUSTRY IS FACING SERIOUS FINANCIAL PROBLEMS. THE FINANCIAL PROBLEMS NOW ARE SOMEWHAT DIFFERENT THAN THEY WERE IN THE EARLY 80's. BACK THEN, THE PROBLEM WAS THAT SAVINGS AND LOANS HAD A LOT OF MORTGAGES ON THEIR BOOKS THAT PAID THEM LESS IN INTEREST THAN THE THRIFTS WERE PAYING THEIR DEPOSITORS. THIS WAS CALLED "NEGATIVE SPREAD" AND WAS CAUSED BY THE APPALLING RUN-UP OF INTEREST RATES BACK THEN.

NOW, HOWEVER, THE PROBLEM IS NOT INTEREST RATE SPREAD. RATHER, IT IS SOMETHING VERY BASIC -- BAD ASSETS. UNFORTUNATELY, A LOT OF THRIFTS HAVE MADE LOANS THAT NOW CANNOT BE REPAID. SOME

OF THESE LOSSES ARE DUE TO BAD MANAGEMENT; SOME ARE DUE TO THE FACT THAT THE ECONOMY IN SOME PARTS OF THE COUNTRY IS STILL NOT IN GOOD SHAPE.

THE NET RESULT, HOWEVER, IS A LEVEL OF INSOLVENCIES IN THE THRIFT INDUSTRY THAT REPRESENTS A REAL CHALLENGE FOR THE HOME LOAN BANK BOARD AND THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION. NOW THERE IS SOME DISPUTE AS TO JUST HOW BAD THE FSLIC PROBLEM IS. WE WILL BE RECEIVING CONSIDERABLE TESTIMONY ON THAT ISSUE THIS MORNING.

IT IS VERY IMPORTANT, HOWEVER, AS WE CONSIDER THESE ISSUES, NOT TO LOSE SIGHT OF ONE FUNDAMENTAL FACT: THE FEDERAL GOVERNMENT STANDS BEHIND FSLIC. NO DEPOSITORS AT ANY OF OUR NATION'S THRIFTS NEED HAVE ANY CONCERN ABOUT THEIR ACCOUNTS UP TO THE FULL INSURED LEVEL.

OPENING STATEMENT OF SENATOR TERRY SANFORD

OVERSIGHT HEARING ON THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION AND THE THRIFT INDUSTRY

MAY 19, 1988

Mr. Chairman, I thank you for calling for this hearing, and particularly want to thank our excellent panel of witnesses for the very detailed and informative testimony they have provided to the Committee.

Before we begin, I want to emphasis that while much of the testimony today expresses concerns about the cost of solving the problems of the thrift industry, no depositors should panic or be unduly concerned. I think it must be said strongly and unequivocally that deposits of up to $100,000 in FSLIC insured savings and loans are absolutely safe. Those deposits are federally insured and the full faith and credit of the United States government stands behind those deposits. Depositors throughout the country can rest assured that money in an FSLIC insured institution is safe, regardless of whatever else may be true about the troubled thrifts in certain regions of the country or the difficulties faced by the FSLIC.

Having said that, I believe there is no doubt that we face a very critical time in the life of our savings and loan industry. As many of you point out, while the great majority, indeed almost 85 percent, of our thrift institutions are healthy and performing well, the minority that are not doing well have sufficient losses to create a serious drag on the entire industry. We all must do everything that we can to see that the problem cases are resolved and resolved quickly in order to ensure that the troubled institutions do not take down the entire industry with them.

We also must examine carefully the problems, particularly in the regulatory structure, that may have contributed to the losses that we are seeing among our problem institutions. To the degree that the problems were exacerbated by inadequate resources and trained personnel for examinations and supervision in a time of deregulated activities, we need to ensure that those resources are now available to FSLIC and that proper oversight is being maintained.

In addition, we must think creatively about how to resolve the problem cases and how to fund the resolution of these cases. We may have reached a point where the healthy institutions simply cannot pay higher premiums to bail out the problem institutions, or where we have created tremendous incentives for our best institutions to leave the system to join the FDIC.

As we begin to examine in detail the extent of the problems facing our savings and loans, I do think it is important for us to keep in mind and for the general public to be reminded that the vast majority of our institutions are sound and healthy and performing well. In my home state of North Carolina, we are proud of the strength of our institutions and of the leadership that has been exerted to keep our financial institutions in good shape. While we need to be honest in addressing the very real problems that the thrift industry faces, it is important that we and the general public are not induced to panic. There are certainly many strong thrift institutions that can be looked to with confidence.

Most importantly, I think it is essential that this Committee understand as completely as possible the nature and the size of the problem that we are facing in order to best analyze how to address the problem. I believe our witnesses this morning have gone a long way toward providing us with the fact, figures and analysis that we need to understand the difficulties facing our savings and loan industry and I look forward to hearing their testimony.

Thank you.

STATEMENT OF SENATOR JOHN HEINZ

FSLIC & Thrift Industry Oversight Hearing

May 19, 1988

MR. CHAIRMAN, NEARLY A YEAR AGO I MENTIONED TO THIS COMMITTEE THAT FSLIC WAS A 'TICKING TIME BOMB." THE JUST-RELEASED GAO REPORT, "Trends in Thrift Industry Performance," CONFIRMS THAT FEAR AND TELLS US THAT THE FUSE IS NOW THAT MUCH SHORTER.

I THINK THAT WE CAN ALL AGREE THAT THE THRIFT INDUSTRY IS AT RISK. IT IS THREATENED BY INCREASING NUMBERS OF INSOLVENT AND INADEQUATELY FUNDED INSTITUTIONS. GAO REPORTS THAT NEARLY 30% OF ALL S&Ls (954 of 3,191) ARE EITHER BANKRUPT OR PERILOUSLY CLOSE.

HOW DID THE S&Ls GET INTO THIS PREDICAMENT? FOR OVER 40 YEARS, THE THRIFTS OPERATED IN A RELATIVELY CALM WATERS, UNTIL THEY GOT BUFFETED BY THE WINDS OF REGULATORY CHANGE BROUGHT ABOUT BY DEREGULATION IN THE EARLY 1980S. MANY OF THESE SLS TOOK GREATER RISKS, THEY DIVERSIFIED AWAY FROM THEIR TRADITIONAL MORTGAGE-BASED ASSETS INTO HIGHER RISKS, MORE VOLATILE INVESTMENTS. AND TOO MANY OF THEM FLOUNDERED.

SOME OF THESE WERE POORLY MANAGED, OTHERS WERE FRADUENTLY MANAGED. AND OVERALL THERE WAS INADEQUATE SUPERVISION. AND JUST ABOUT A YEAR AGO WE AMERICANS STARTED TO LOSE CONFIDENCE IN THEIR THRIFT INSTITUTIONS.

THAT IS WHY, LAST MARCH I INTRODUCED A RESOLUTION REAFFIRMING THAT FEDERALLY INDUSRED DEPOSIT~~I~~S WILL BE BACKED BY THE FULL FAITH AND CREDIT OF THE U.S.

WHEN WE PASSED CEBA LAST YEAR WE WENT A LONG WAY TOWARDS REASSURING AMERICANS WHO WERE WORRIED ABOUT FSLIC'S DIFFICULTIES AND FEARED THAT THEIR SAVINGS WERE AT RISK.

CAO NOW INFORMS US THAT FSLIC'S LIABILITIES HAVE MORE THAN DOUBLED IN THE PAST YEAR, FROM $6.9B IN 1986 TO $17B IN 1987.

I AM AFRAID THAT FSLIC IS A VERY SICK PATIENT, AND TO RESTORE IT TO HEALTH WILL FAR EXCEED THE PATIENT'S ABILITY TO PAY.

MR. CHAIRMAN, I COMPLIMENT YOU ON HOLDING THIS SERIES OF HEARINGS ON THE CONDITION OF THE THRIFT INDUSTRY. WE WILL HAVE TO MOVE QUICKLY, YET JUDICIOUSLY TO RESOLVE THESE PROBLEMS AND AVOID A FURTHER LOSS OF CONFIDENCE IN THE S&LS.

Alfonse D'Amato

STATEMENT OF SENATOR ALFONSE D'AMATO
BEFORE THE SENATE BANKING COMMITTEE
HEARING ON FSLIC AND THE THRIFT INDUSTRY
MAY 19, 1988

MR. CHAIRMAN, I WANT TO WELCOME OUR PANEL THIS MORNING. EACH IS AN EXPERT IN THE AREAS WE'RE GOING TO DISCUSS AND I LOOK FORWARD TO THEIR TESTIMONY. LAST YEAR, WHEN WE MARKED UP AND PASSED THE COMPETITIVE EQUALITY IN BANKING ACT INCLUDING A RECAPITALIZATION PLAN FOR THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION, WE KNEW - WE KNEW - THAT THE FUNDS WE WERE MAKING AVAILABLE WOULD NOT BE ENOUGH TO ADDRESS, LET ALONE SOLVE, THE PROBLEMS OF THE THRIFT INDUSTRY. AND WHAT CAME OUT OF THE HOUSE-SENATE CONFERENCE WAS, TYPICALLY, A POLITICAL COMPROMISE. AS SUCH COMPROMISES OFTEN ARE, IT, TOO, WAS INADEQUATE.

IF IT WASN'T CLEAR TO EVERYONE THEN, IT SHOULD BE NOW. THE YEAR THAT HAS PASSED SINCE HAS ONLY BROUGHT EVERMORE SPECTACULAR AND DANGEROUS FAILURES AND NEAR FAILURES IN THE THRIFT INDUSTRY, POTENTIALLY EFFECTING HUNDREDS OF THOUSANDS OF DEPOSITORS AND IMPERILING THE SOUNDNESS OF OUR FINANCIAL SYSTEM.

I AM NOT SAYING ALL IS DOOM AND GLOOM; SERIOUS AND SIGNIFICANT EFFORTS HAVE BEEN MADE IN THE PAST YEAR TO DEAL

WITH THE MOST ACUTE PROBLEMS IN THE INDUSTRY. IN THE LAST TWO WEEKS, FOR EXAMPLE, TWO TEXAS TRANSACTIONS HAVE BEEN STRUCTURED BY FSLIC THAT MERGE FAILING S&L's WITH SOUNDER INSTITUTIONS. THE SECOND OF THESE, ANNOUNCED JUST YESTERDAY, MERGING FOUR THRIFTS WITH THE SOUTHWEST SAVINGS ASSOCIATION, IS THE LARGEST SUCH DEAL YET ARRANGED. THESE ARE HOPEFUL DEVELOPMENTS DEMONSTRATING THAT WITH THE COMMITMENT OF EXPERTISE AND AN AGGRESSIVE APPROACH, SOLUTIONS CAN BE FOUND THAT MINIMIZE FEDERAL INSURANCE PARTICIPATION.

NEVERTHELESS, DESPITE THESE EFFORTS, ANY INDUSTRY-WIDE SOLUTION IS GOING TO TAKE TIME AND A LOT MORE MONEY.

ALTHOUGH I HAVE FOUND ALL OF THE TESTIMONY TO BE OF GREAT INTEREST, I WOULD LIKE TO FOCUS ON THE GAO STATEMENT PREPARED BY MR. WOLF. THOUGH STATED WITH APPROPRIATE DEFERENCE AND CAUTION, IT NEVERTHELESS STRAIGHTFORWARDLY STATES WHAT WE ALREADY KNOW: CURRENT FUNDING OF FSLIC IS NOT NEARLY ADEQUATE. AS THE REPORT POINTS OUT, ALTHOUGH ALMOST TWO-THIRDS OF THE S&L INDUSTRY WAS PROFITABLE IN 1987, EARNING $6.6 BILLION, THESE PROFITS WERE FAR OUTWEIGHED BY THE $13.4 BILLION LOSS EXPERIENCED BY THE OTHER THIRD.

MORE ALARMINGLY, AT THE END OF 1987, OVER 500 INSOLVENT INSTITUTIONS WITH A COMBINED NEGATIVE NET WORTH ESTIMATED AT $18 BILLION WERE STILL OPERATING.

ACCORDING TO THE REPORT, FSLIC HAD A 1987 OPERATING LOSS OF $8.6 BILLION, LEAVING IT WITH A $13.7 BILLION DEFICIT - DOUBLE THAT OF THE YEAR BEFORE. MORE TO THE POINT, FSLIC'S FINANCIAL STATEMENTS REFLECT A LIABILITY OF MORE THAN $17 BILLION FOR THE MORE THAN 200 INSOLVENT THRIFTS FOR WHICH FSLIC ALREADY HAS ASSUMED RESPONSIBILITY. OBVIOUSLY, NO ONE DOUBTS THAT THAT "CASELOAD" WILL ONLY GROW. SOME OF THESE CASES WILL NOT BE RESOLVED FOR YEARS.

LET ME EMPHASIZE, MR. CHAIRMAN, THAT THAT LIABILITY IS NOT A "PROJECTED" LOSS. INSTEAD IT IS THE COST TO RESOLVE CURRENTLY ASSUMED OBLIGATIONS. THE EXTENT OF FSLIC'S FURTHER EXPOSURE CAN BE GUESSED AT IN LIGHT OF THE FACT THAT, AS OF THE END OF LAST YEAR, ALMOST 300 ADDITIONAL INSTITUTIONS (ASSETS: $88 BILLION) WERE INSOLVENT.

THERE IS A LONG WAY, MR. CHAIRMAN, TO ANY LIGHT AT THE END OF THAT TUNNEL.

TO ME, MR. CHAIRMAN, THE MOST IMPORTANT CONCLUSION OF THE GAO STUDY IS THAT "EXPERIENCE CLEARLY SHOWS THAT DELAYING RESOLUTION WILL, INCREASE FSLIC'S ULTIMATE COSTS BY ALLOWING THESE INSTITUTIONS TO CONTINUE INCURRING LOSSES." IN OTHER WORDS, DELAYING - FOR WHATEVER REASONS, POLITICAL OR OTHER - A REALISTIC STATEMENT OF THE SCOPE OF THE PROBLEM AND OF WHAT FSLIC WILL NEED TO ADDRESS IT ONLY MAKES MATTERS WORSE.

THE TIME TO BITE THE FISCAL BULLET IS NOW. IF AT SOME POINT A MAJOR INFUSION OF TAXPAYER FUNDS IS REQUIRED TO MANAGE THIS FAILING INDUSTRY, THE REGULATORS SHOULD ASK FOR IT AND THIS COMMITTEE SHOULD FACE IT NOW RATHER THAN LATER.

I AM NOT ADVOCATING THAT BAILOUT; I HAVE NOT CONCLUDED THAT IT IS NECESSARY, OR THE MOST APPROPRIATE AND EFFECTIVE APPROACH.

NEVERTHELESS, MR. CHAIRMAN, IT'S TIME TO CALL A SPADE A SPADE. IF THAT IS WHAT THE REGULATORY EXPERTS ARE GOING TO ASK US FOR, WE NEED TO HEAR IT. WE DON'T NEED ANYMORE POLITICAL SHADOWBOXING. IN THE LONG RUN THAT WILL ONLY COST US A LOT MORE, AND DELAY A REALISTIC APPRAISAL OF WHAT IS NEEDED.

THANK YOU, MR. CHAIRMAN.

The **Chairman**. Gentlemen, we're very happy to have such an expert and distinguished panel on what is such an absolutely critical problem. I'm going to ask each of you to make your remarks, if you can, in 10 minutes or less. If you're less than 10 minutes, we'll place a higher premium on your words of wisdom. [Laughter.]

Mr. Wolf, we're happy to have you start off, sir.

STATEMENT OF FREDERICK D. WOLF, DIRECTOR, ACCOUNTING AND FINANCIAL MANAGEMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Mr. **Wolf**. Thank you, Mr. Chairman.

We are pleased to appear today to discuss the results of our audit of the FSLIC, the insurance fund's financial condition, and its ability to deal with the increasing number of insolvent and inadequately capitalized institutions.

You have our full statement which we would like to submit for the record. Let me just summarize it in 4 or 5 minutes.

The **Chairman**. Without objection, that will be printed in full in the record.

DIVERSIFICATION BY THRIFTS

Mr. **Wolf**. As you and other members of the committee are well aware, during the last decade the thrift industry's traditional and safe environment has disappeared as the industry has struggled to remain competitive and profitable. Many thrifts began to diversify their asset portfolios away from traditional residential mortgage loans and into potentially more profitable but riskier activities, many of which were predicated upon continued increases in real estate values in order to make them economically viable.

However, due to the economic downturn in the agriculture and more importantly the oil and gas sectors of our economy, such increases were not sustained.

Diversification into riskier activities, the regulatory lag in keeping up with some of those activities, the high cost of funds, and the severe economic downturn have left many thrifts with significant losses on their portfolios.

S&L's have had to absorb substantial losses on their loans and the outcome has been an alarming number of S&L failures and a large segment of the industry saddled with asset quality problems.

Although almost two-thirds of the industry was profitable in 1987, these profits were far outweighed by the $13 billion loss which was experienced by the remaining one-third of the S&L industry, primarily those located in the Southwest. These losses in fact continued into the first quarter of 1988 with an industry loss of an additional $3 billion.

At the end of 1987, over 500 savings and loan institutions were insolvent and had a negative net worth of $18 billion.

$13.7 BILLION DEFICIT FOR FSLIC IN 1987

While the industry has been struggling, FSLIC has also suffered. Our 1987 audit shows that FSLIC had a net operating loss of almost $9 billion, resulting in a $13.7 billion deficit, more than double the 1986 deficit.

FSLIC's operating loss was primarily attributable to a $7 billion increase in its liability for failed but still operating thrift institutions. That liability now totals about $17 billion.

While some have suggested that the $17 billion liability does not represent a real loss to FSLIC, we would dispel that myth. Those losses are real. The fact that FSLIC cannot resolve all of its cases does not diminish its liability, although it does increase the cost.

It is also important to note that the $17 billion liability is not a projection of the cost to resolve all of the known problems in the industry. At the end of 1987, there were an additional almost 300 insolvent institutions. FSLIC believes that the negative net worth of those institutions, which is about $5.5 billion, indicates the approximate cost of resolving those institutions. We believe that this estimate may substantially understate the magnitude of the financial assistance which those S&L's will need.

Our estimates of the cost to deal with those additional 300 institutions using historical factors would indicate a potential cost ranging from $9 to $19 billion.

That's the condition of FSLIC today. Let me now turn to the outlook for FSLIC.

FSLIC believes that it's going to have the resources available to effectively resolve the industry's problems and has provided us with a 10-year projection of funds which it hopes to have available and the corresponding outlays that it expects to incur.

Over the next 10 years FSLIC expects to have about $28 billion, in net new funds, primarily from insurance premiums and the sale of the recap bonds, which would be available for resolution of cases.

In developing its projection, however, FSLIC has made several assumptions that we believe are relatively optimistic and, as with any projection, may well prove incorrect. FSLIC bases its revenue projections on several assumptions, including a doubling of insured deposits over the next 10 years, even though the moratorium on exits from the system expires in August; stable and relatively low interest rates; and a continuation throughout the next 10 years of the special assessment.

FSLIC assumptions also further imply that other financial institutions will not be able to take away any substantial portion of the traditional S&L business.

If such assumptions do not prove correct, FSLIC's projections may well fall short of its goals.

Also implicit in FSLIC's forecast is the expectation that a large portion of the problem institutions can be dealt with by merging them with other presumably healthier thrifts rather than liquidating them. This assumption tends to be inconsistent with the historical pattern we've seen so far.

FSLIC also further assumes that resolutions will be less expensive in the future than they've been in the past and that resolutions will occur rapidly.

Last, the projection assumes virtually no new problem cases beyond those already identified. It's understandable that FSLIC faces its challenge with a high degree of optimism. While we believe that FSLIC's projections and their underlying assumptions are relatively optimistic, we do not question the sincerity or the ability of those who developed them. Nevertheless, we conclude that the eventual costs of restoring the thrift industry to financial health are likely to exceed the funds that FSLIC will have available.

In addition, because of the distressed financial condition of a large segment of the industry, it also appears unlikely that the industry will have the resources to provide such funding.

Consequently, further congressional action may well be needed to obtain adequate funding. FSLIC does have sufficient resources to continue operating and resolve cases in the near term. They have established an ambitious plan for resolving these cases fairly rapidly. Whether or not they are able to effectively accomplish this plan should become readily apparent in the near future.

Mr. Chairman, that concludes my statement. I'd be glad to answer any questions.

[The complete prepared statement of Mr. Wolf follows:]

United States General Accounting Office

GAO Testimony

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The Federal Savings and Loan Insurance Corporation--Current Financial Condition and Outlook

Statement of
Frederick D. Wolf, Director
Accounting and Financial Management Division

Before the
Committee on Banking, Housing and Urban Affairs

United States Senate

GAO/T-AFMD-88-12

GAO Form 160 (12/87)

Mr. Chairman and Members of the Committee:

We are pleased to appear today to discuss the results of our audit of the Federal Savings and Loan Insurance Corporation's (FSLIC) 1987 financial statements, the insurance fund's precarious financial condition, and FSLIC's and the Federal Home Loan Bank Board's ability to resolve the growing threat to the insurance fund and savings and loan (S&L) industry presented by the increasing number of insolvent and inadequately capitalized institutions. I would first like to provide some background on how a large segment of the industry got into this critically deteriorated financial condition, which will serve to underscore the seriousness and magnitude of the problems the troubled sector of the S&L industry faces and provide perspective on the resources FSLIC needs to deal with problem institutions.

THE SAVINGS AND LOAN INDUSTRY'S TRANSFORMATION

For over 40 years, the thrift industry operated in a relatively simple and safe environment in which deposits generated from the local economy at regulated interest rates were invested in traditional home mortgages. However, during the last decade, that simple environment has disappeared as the industry has struggled to remain competitive and profitable. During this time,

- -- restrictions on interest rates that could be paid on deposits were progressively lifted,
- -- competition for deposits escalated,
- -- S&Ls had to pay increasingly higher interest rates to preserve their core deposits at the same time that they were encumbered with low-yielding loan portfolios,
- -- S&Ls were permitted to expand their operations into assets traditionally reserved for banks, such as commercial and consumer lending, and
- -- various states dramatically expanded the types and extent of investment activities in which state-chartered S&Ls could participate.

Diversification Into Non-traditional Assets

The expansion of asset and investment activities is particularly noteworthy. Many thrifts began to diversify their asset portfolios away from traditional residential mortgage loans and into other potentially more profitable but possibly riskier activities, many of which were predicated upon continued increases in real estate values to make them economically viable. Such activities included:

-- acquisition, development, and construction loans, with S&Ls often providing 100 percent financing, and on which payment depends upon a project being completed and achieving profitability;

-- direct investment in real estate and equity securities, profit on which generally depends upon economic factors beyond the thrifts' control;

-- land speculation; and

-- participation loans on which S&Ls often used lax underwriting standards, with the participating S&Ls relying on the loan originator to adequately evaluate the soundness of the loans.

While such activities are potentially more lucrative than traditional home mortgage loans, they require expertise that many S&Ls did not have. Moreover, returns from these ventures are more volatile than traditional home mortgages and such activities are among the first affected by economic downturns.

Non-traditional Funding Sources

To fund these potentially more lucrative, but possibly riskier activities and to fund rapid growth--which was often erroneously assumed to equate to higher profits--many S&Ls began to rely to a greater extent on non-traditional sources of funds. Specifically, many S&Ls began selling their traditional home mortgage loans, thus eliminating a stable source of income. Accepting brokered deposits also became a widespread means of obtaining funds, especially by troubled thrifts willing to pay a premium to get funds needed to continue operating. Such funds are not only costly but also are usually very volatile, shifting from one institution to another to obtain a higher rate of return. Thus, if such funds are withdrawn, as brokered deposits often are, an already troubled S&L's financial condition could be critically affected.

Imprudent and Dishonest Operators Enter Market

Compounding the problems resulting from rapid asset diversification and from the high cost of rapid growth was the entry of some imprudent and dishonest operators into the S&L industry. Many of these "high fliers" used their S&Ls as private piggy banks to finance lavish lifestyles and to engage in speculative business activities. Failing to follow Bank Board regulations, including those pertaining to insider loans and loans to a single borrower were evident in many of the largest S&L failures.

Impact on the Supervisory Process

As a result of the industry's rapid transformation, supervisory and examination personnel became responsible for monitoring a diversified and complex industry engaged in sophisticated and often unprecedented financial activities. At the same time, the Bank Board's supervisory and examination activities suffered from high employee turnover and staff inexperienced in the new, complex activities of thrifts. Moreover, until 1985, due in large part to hiring and salary limitations, the Bank Board was unable to increase the size of its staff to deal with the newly deregulated and rapidly expanding industry. This combination of factors served to exacerbate an already troubled situation in the industry by potentially delaying recognition of problems at an early stage when they possibly could have been contained.

Economic Downturn in Certain Sectors of the Economy

Perhaps the most damaging blow to the savings and loan industry was the economic downturn in the agricultural and, more importantly, the oil and gas sectors of the economy. The dramatic increase in energy prices in the early-1980s fueled tremendous growth and rapid inflation of real estate values in the Southwest. However, the equally dramatic and rapid decline in energy prices in the mid-1980s caused the bottom to fall out of the real estate industry in that area of the country. This drastic decline in real estate values substantially altered the savings and loan industry's financial condition and accelerated its downward slide.

THE S&L INDUSTRY'S FINANCIAL CONDITION

Diversification into riskier activities, high cost of funds, and insufficient supervision, coupled with severe economic downturn in certain sectors of the economy, have left many thrifts with little except enormous losses from their poor quality assets. While rapidly declining interest rates began to correct the interest rate spread problems of the late-1970s and early-1980s, S&Ls began having to absorb substantial losses on their loans and investments. The outcome has been an alarming number of S&L failures, and a large segment of the industry saddled with asset quality problems. Although almost two-thirds of the industry was profitable in 1987, earning $6.6 billion, these profits were far outweighed by the $13.4 billion loss experienced by the remaining one-third of the 3,147 FSLIC-insured institutions, located primarily in the Southwest. In addition, although 211 S&Ls were closed or merged between 1983 and 1987, at the end of 1987, over 500 insolvent institutions with negative net worth of $18 billion, as measured by generally accepted accounting principles, were still operating. An additional 435 institutions with assets of $255 billion were barely solvent, with net worth ratios between

0 and 3 percent. For your information, we are providing two tables that show in detail the condition of the thrift industry. (See attachments I and II.)

Over the past 2 years, the Federal Home Loan Bank Board has acted to limit S&Ls' and FSLIC's exposure to certain investments and loans. Specifically, the Bank Board has increased the supervisory and examination staff and has adopted regulations to limit direct investments and certain highly risky loans, increase capital requirements, and require S&Ls to begin reporting in accordance with generally accepted accounting principles. While we support the Bank Board's actions, and believe they may minimize future losses related to such activities, these actions were too late to reduce the enormous problems the industry and FSLIC face.

In addition, it now appears that S&Ls are entering into newer and more complex financial transactions that potentially expose FSLIC to additional significant risks. These transactions include risk controlled arbitrage, in which some institutions fund rapid growth by using short-term liabilities to add long-term assets. While such arrangements offer potentially higher returns, they also carry commensurate risk and require a high level of expertise to manage. Also, recently, an investment firm attempted to create new financial instruments--Real Estate Mortgage Investment Conduit certificates created from "underwater mortgages." This transaction was intended to enable financial institutions with below market yield mortgage-backed securities or mortgages to "sell" these assets and, surprisingly, record a gain on the sale. While it appears this scheme never got off the ground, the potential for developing other "creative" transactions exists. Any new activities, especially complicated financial instruments and arbitrage schemes, require a great deal of expertise, and are not, by any stretch of the imagination, risk-free. Nor are they a quick and easy solution to the industry's financial woes. Instead, if not adequately monitored and controlled, they may do much more harm than good.

FSLIC'S CURRENT FINANCIAL CONDITION

We have just completed our audit of FSLIC's 1987 financial statements and will be issuing our report on that audit shortly. A copy of our opinion, which will be delivered to the Corporation, and a summary of FSLIC's financial statements are attached to this statement. (See attachments III and IV.) These statements indicate continuing deterioration of FSLIC's financial condition, and raise serious questions about its ability to deal with the industry's still growing problems.

During 1987, FSLIC had a net operating loss of $8.6 billion, resulting in a $13.7 billion deficit--more than double its 1986 deficit. FSLIC's operating loss was primarily attributable to the $6.9 billion increase in its liability for failed but still operating thrift institutions, as well as $3.5 billion in losses for institutions that have received financial assistance or have already closed.

1987 Loss Provision for Unresolved Cases

The attached summary financial statements reflect a liability of more than $17 billion for resolving the problems of the more than 200 insolvent institutions for which FSLIC has assumed responsibility and for several others FSLIC expects to deal with in 1988. This liability increased by $6.9 billion in 1987 due to the growing number of critically distressed open thrifts and to the increasing cost related to resolving their problems. During 1987, FSLIC's caseload of seriously troubled thrifts increased from 183 to 205 and included 138 thrifts that were in its 1986 caseload. These thrifts continued to incur large operating losses, thus further increasing FSLIC's eventual resolution costs.

While some have suggested that these losses are not "real" but only contingent in nature, we would dispel that myth. The term "contingent" in no way applies to the loss estimates developed for FSLIC's caseload. The institutions involved have incurred actual losses, as evidenced by their negative tangible net worth, and FSLIC's costs to resolve institutions' problems have historically exceeded negative tangible net worth. The fact that FSLIC cannot resolve all cases for several years does not diminish its liability. Instead, experience clearly shows that delaying resolution will increase FSLIC's ultimate costs by allowing these institutions to continue incurring losses. In this regard, the industry reported further capital losses of $3.3 billion in the first quarter of 1988.

The $17 billion liability at December 31, 1987, is not a projection of the cost to resolve all known problems in the industry. Instead, as previously noted, it is primarily the estimated cost to resolve the problems of those insolvent institutions for which FSLIC had assumed responsibility. At December 31, 1987, almost 300 additional institutions with assets of about $88 billion were insolvent, exposing FSLIC to further risk. A precise estimate of the eventual cost to resolve problems of those additional institutions cannot presently be made because the cost depends upon various uncertainties, such as the quality of each institution's assets, future interest rates, and the economic outlook for certain sectors of the economy in which many of the troubled institutions operate. FSLIC believes that the negative tangible net worth of those institutions indicates that the cost will be at least $5.3 billion. We believe that this estimate may substantially understate the magnitude of financial assistance the S&Ls will need for two reasons--probable future operating losses and historical experience. We expect these S&Ls, which have been incurring losses and which FSLIC will not act on for several years, to incur future losses, thus increasing the eventual costs FSLIC must absorb. In addition, the historical costs of resolving S&Ls' problems have consistently exceeded the reported negative tangible net worth of those institutions. Over the last 3 years, liquidating and merging S&Ls cost FSLIC, on average, more than 20 percent of an institution's assets and generally exceeded negative tangible net worth by almost 70 percent. Estimates of FSLIC's ultimate cost to deal with these additional S&Ls, using historical factors, would indicate a potential cost for the 300 additional institutions substantially in excess of the currently reported $5.3 billion negative tangible net worth, and range from $9 to $19 billion.

1987 Loss Provision for Resolved Cases

During 1987, FSLIC paid off or transferred insured depositors' accounts in 17 insurance actions. As a result, FSLIC made claims of $2.8 billion against the closed institutions' assets, which were transferred to receiverships for liquidation at the time the S&Ls were closed. However, because the loans and real estate of the failed thrifts are of extremely poor quality, FSLIC only expects to recover 39 percent of its claims from the sale of assets of institutions liquidated in 1987. In total, at December 31, 1987, FSLIC had $11.6 billion in claims against all receiverships, of which it expects to recover only $4.9 billion, or 42 percent of its claims.

In addition, in 1987, FSLIC losses related to assistance agreements for the merger or acquisition of failed thrifts increased by more than 150 percent over the previous year. FSLIC's 1987 loss provision of $1.7 billion includes the estimated cost of the 31 institutions merged or sold in 1987, as well as adjustments to estimated costs of prior years' mergers and acquisitions. Between 1981 and 1987, FSLIC spent a total of $4.6 billion to provide such assistance. However, this expenditure may not reflect final resolution costs for those institutions. Some mergers have resulted in institutions so poorly capitalized that further costly action may be necessary. For example, four institutions that acquired failed thrifts with FSLIC assistance during 1987 had negative tangible net worth at the end of the year.

OUTLOOK FOR RESOLVING THE INDUSTRY'S PROBLEMS

As previously noted, a significant number of S&LS are insolvent and continue to incur sizable losses. The problems of these institutions are of such magnitude they clearly cannot be resolved without substantial financial assistance. At the same time, FSLIC's financial condition and, thus, its ability to provide such assistance, is severely distressed. Nonetheless, FSLIC believes that it will have the resources available to effectively resolve the industry's problems, and has provided us with a 10-year projection of funds it expects to have available, and the corresponding outlays it expects to incur.

Over the next 10 years, FSLIC expects to have about $28 billion in net new funds from regular and special assessments and from the sale of bonds authorized by the Competitive Equality Banking Act of 1987 (CEBA), as well as from the sale of assets from existing receiverships available for resolutions. However, in developing its projection, FSLIC has made several assumptions that are relatively optimistic and, as with any projection, may prove incorrect. We have carefully reviewed the projection and its underlying assumptions and have concluded that, while FSLIC has the resources to continue operating in the near future, it may not have sufficient resources to effectively deal with the industry's current and future problems.

Ability to Merge Rather Than Liquidate

Implicit in FSLIC's forecast is the expectation that almost all of the problem institutions can be dealt with by merging them with other, presumably healthier, thrifts, rather than liquidating them. Using these assumptions results in a lower cost than if more liquidations were expected because, historically, it has been significantly less costly for FSLIC to arrange for a troubled institution's assets and liabilities to be assumed by another, financially strong institution rather than close an institution and pay off its insured depositors. Specifically, between 1985 and 1987, merger costs were 16 percent of the merged institutions' assets, while liquidation costs were 49 percent of the institutions' assets.

Unfortunately, the premise that almost all of the industry's problem cases can be resolved through mergers is inconsistent with resolution actions over the past 5 years. Of 179 transactions FSLIC completed during that period, 66, or 37 percent, were liquidation-type transactions, while 113 were mergers or acquisitions. Recent activity does not indicate a trend toward mergers. Between January 1, 1988 and April 30, 1988, FSLIC accomplished 22 transactions--10, or 45 percent, were liquidations, and 12 were mergers or acquisitions. While FSLIC and the Bank Board may hope to accomplish more mergers in the future, we do not believe that in prior years they would have chosen liquidation--the more costly form of resolution--if a merger would have been cheaper and equally effective.

The Bank Board has stated that a large number of potential investors have expressed interest in acquiring thrifts with FSLIC assistance. However, the availability of suitable merger partners willing to absorb large numbers of insolvent institutions at favorable terms is still unproven. S&Ls in the region of the country where most of the troubled thrifts are located are in significantly worse shape than those in the rest of the country.

To illustrate, the 479 thrifts in the Dallas Federal Home Loan Bank district, the district with the most insolvent thrifts, had negative net worth of $6.7 billion at December 31, 1987.

Additionally, FSLIC assumes that investors will be willing to accept FSLIC notes, rather than cash, as an acceptable form of assistance. In view of FSLIC's precarious financial condition, we believe the degree to which FSLIC notes will be accepted as substitutes for cash remains an open question.

We want to emphasize that simply merging two or more weak institutions into a larger one does not necessarily represent a problem resolution. For such a consolidation to offer promise of stability, the resulting entity must normally be well capitalized, which usually requires a substantial infusion of high quality assets.

Lower Resolution Costs

FSLIC also assumes that future resolutions will be less expensive than in the past and that resolutions will occur rapidly, minimizing additional losses to insolvent thrifts and FSLIC's costs, with virtually no new problem cases beyond those already identified. For the currently insolvent institutions not included in its $17.4 billion liability, FSLIC projects resolution costs equal to the institutions' negative tangible net worth--about $5.3 billion. However, based on experience, this estimate is optimistic. As previously discussed, using historical resolution costs as a percentage of assets to estimate the costs for these institutions indicates that resolution costs could reach $19 billion.

FSLIC also forecasts incurring over $14 billion in resolution costs during fiscal years 1988 and 1989, and assumes that virtually no new resolutions will be required after fiscal year 1992. Neither 1987's performance (52 resolutions) nor resolutions accomplished thus far in 1988 (22 through April 1988) indicate that FSLIC can act on cases this rapidly. Moreover, FSLIC's assumption that no new problem cases will develop appears extremely optimistic in view of the industry's current condition and most recent operating results. In particular, if interest rates should significantly increase, S&Ls could be faced with the interest rate spread problems that occurred 10 years ago.

Revenue Projections

FSLIC's revenue projections are based on several relatively optimistic assumptions regarding interest rates and future conditions in the savings and loan industry and in the U.S. financial markets. The effects of these assumptions are interrelated--should future conditions vary significantly, both FSLIC's projected revenues and outlays could be adversely affected.

-- Growth in Deposits at Insured Institutions - FSLIC assumes that insured deposits will grow about 7 percent annually, roughly doubling insured deposits over 10 years. Because FSLIC's premium income (both regular and special assessments) is based upon fixed percentages of insured deposits, its revenues increase significantly under this scenario. While this growth rate is consistent with the overall growth experienced over the past decade, we believe it may be overly optimistic. While deposits grew dramatically in 1983 and 1984, the growth rate declined in 1985, 1986, and 1987. Moreover, CEBA imposed a moratorium on thrifts leaving the FSLIC system which expires in August 1988--any significant departures of thrifts would result in corresponding decreases in deposit growth. This assumption further implies that other financial institutions are not able to take away any substantial portion of the thrift industry's current business.

-- Special Assessment Income - FSLIC's forecast assumes FSLIC will continue the special assessment of 1/8 of 1 percent of insured deposits throughout the next 10 years. However, under CEBA the special assessment was to be phased out by 1991. Although CEBA contains provisions permitting the Bank Board to continue the special assessment under certain circumstances, the Bank Board has not officially indicated what it plans to do. Moreover, continuation of the special assessment could encourage healthy thrifts to transfer to the Federal Deposit Insurance Corporation, thus eroding the deposit base from which FSLIC's premium income is generated. Conversely, without continuing the special assessment, there is no shred of hope of resolving FSLIC's financial plight without turning to the taxpayer.

-- Recapitalization Bonds and Related Interest Expenses - FSLIC's revenue forecast projects that recapitalization bonds will be marketed at interest rates of slightly less than 10 percent, which has been the case thus far. While FSLIC receives the proceeds from the bond sales, it must also bear the interest costs on the bonds. The interest costs will be paid from FSLIC's assessment income over the 30-year life of the bonds. Thus, significant increases in overall interest rates would reduce FSLIC's funds. Such a reduction would be compounded if higher interest rates were accompanied by slower deposit growth than FSLIC anticipates.

Other Sources of Funds

In addition to funds from recapitalization proceeds, insurance premiums, investment income, and liquidating assets, FSLIC and the Bank Board have access to funds from other sources.

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However, each of these sources has drawbacks, and most do not add to FSLIC's reserves because the money must be repaid.[1]

-- Borrowing From the Treasury - FSLIC has a $750 million line of credit available if the Bank Board determines funds are needed for insurance purposes.

-- Borrowing From the Federal Reserve System - FSLIC can borrow directly from the Federal Reserve System under two different authorities and indirectly under one other authority. The amount available under each authority depends upon the amount of suitable collateral at FSLIC's disposal.

-- Borrowing From the Federal Home Loan Banks - FSLIC is authorized to borrow from the Bank system under certain limitations.[2] In addition, if the Secretary of the Treasury and the Chairman of the Bank Board certify to the Congress that alternative means of raising funds cannot be used and the ability to supply such funds is impaired, the Treasury can purchase up to $4 billion of Federal Home Loan Bank obligations, which could then be used to assist the thrift industry.

-- Mandatory Infusion of Up To 1 Percent of Withdrawable Deposits Into FSLIC - The Bank Board is authorized to require insured S&Ls to make such deposits into FSLIC. According to Bank Board officials, FSLIC could raise over $9 billion in this manner; however, its liabilities would increase by an equal amount.

FSLIC has not included funds from these sources in its projection and we agree with that decision. In our view, these sources are accompanied by serious disadvantages, and their use should only be considered in an extreme emergency.

GAO'S VIEW ON FSLIC'S ABILITY TO DEAL WITH THE INDUSTRY'S PROBLEMS

As previously discussed, we view FSLIC's projections with significant reservations. It is understandable that FSLIC faces its challenges with a high degree of optimism. While we believe FSLIC's projections and their underlying assumptions are relatively optimistic, we do not question either the sincerity or the ability of those who developed them. Nonetheless, depending upon the outcome of the various uncertainties underlying FSLIC's projections, we conclude that the eventual costs of restoring the thrift industry's financial health are likely to exceed the funds that FSLIC will have available. In addition, because of the distressed financial condition of a large segment of the industry, it also appears unlikely that the industry would have the resources to provide such funding. Consequently, further congressional action may well be needed to obtain adequate funding.

However, as we said earlier, FSLIC does have sufficient resources to continue operating and resolve cases in the near term. FSLIC has established an ambitious plan for rapidly resolving cases. Whether or not FSLIC can effectively accomplish this plan should become readily apparent in the near future.

In closing, we would like to emphasize our view that if congressional action becomes necessary, it should be taken swiftly. Any delays in acting on insolvent thrifts inevitably result in increased resolution costs and undermine the stability of all financial institutions. Such has been the bitter lesson of the current thrift industry crisis.

Mr. Chairman, this concludes my formal statement. At this time, I would be pleased to answer any questions you may have.

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[1] For more detailed information on these sources of funds, see Thrift Industry: The Treasury/Federal Home Loan Bank Board Plan for FSLIC Recapitalization (GAO/GGD-87-46BR, March 3, 1987).

[2] FSLIC has used this authority twice to fund pass-through loans to insured institutions.

SELECTED FINANCIAL INFORMATION FOR SAVINGS AND LOAN INSTITUTIONS AS OF DECEMBER 31, 1987

($ in billions)

GAAP Net Worth (%)	Number of S&Ls	Percent of Total	Total Assets	Total Deposits	GAAP Net Worth
Less than -12%	182	5.8	$ 43.2	$ 49.3	$(14.2)
From -12 to -9%	33	1.1	5.5	4.7	(0.6)
From -9 to -6%	61	1.9	23.0	19.6	(1.7)
From -6 to -3%	75	2.4	17.5	14.8	(0.7)
From -3 to 0%	154	4.9	51.1	40.4	(0.7)
From 0 to 3%	435	13.8	255.2	175.7	4.0
From 3 to 6%	1,014	32.2	555.9	398.7	25.0
From 6 to 9%	743	23.6	231.0	177.1	15.9
From 9 to 12%	290	9.2	38.6	31.6	3.9
More than 12%	160	5.1	30.7	20.9	6.0
Total	3,147	100.0	$1,251.7	$932.8	$36.9

SELECTED FINANCIAL INFORMATION FOR SAVINGS AND LOAN INSTITUTIONS IN THE DALLAS FEDERAL HOME LOAN BANK DISTRICT AS OF DECEMBER 31, 1987

($ in billions)

GAAP Net Worth (%)	Number of S&Ls	Percent of Total	Total Assets	Total Deposits	1987 Net Income	GAAP Net Worth
Less than 0 %	181	37.8	$ 59.4	$ 57.1	$(6.51)	$(10.16)
From 0 to 3%	91	19.0	35.4	26.1	(0.44)	0.59
From 3 to 6%	118	24.6	25.7	19.6	(0.12)	1.12
More than 6%	89	18.6	13.2	9.9	0.04	1.79
Total	479	100.0	$133.7	$112.7	$(7.03)	$(6.66)

TO BE DELIVERED

To the Chairman
Federal Home Loan Bank Board

We have examined the consolidated statements of financial condition of the Federal Savings and Loan Insurance Corporation as of December 31, 1987 and 1986, and the related consolidated statements of income and expense and reserves, and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted government auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. In addition to this report on our examination of the Corporation's 1987 and 1986 consolidated financial statements, we are also reporting on our study and evaluation of internal accounting controls and compliance with laws and regulations.

SAVINGS AND LOAN INDUSTRY'S FINANCIAL CONDITION

Over the past decade, the savings and loan industry has experienced severe financial difficulties. During this time, as restrictions on deposit rates were progressively lifted and competition for deposits escalated, savings and loan associations had to pay increasingly higher interest rates to preserve their core deposits at the same time they were encumbered with low-yielding loan portfolios. The resulting negative interest rate spread led to large industry-wide operating losses and capital depletion in 1981 and 1982. With the liberalization in the early-1980s of the types of activities in which thrifts could participate, many institutions began to diversify their asset portfolios away from traditional home mortgage loans and into other activities. These activities included transactions such as acquisition, development, and construction loans, and various direct investments, which offer potentially higher rates of return, but carry commensurate risk. Moreover, the profitability of many of these activities was predicated upon continued increases in real estate values to make them economically viable.

Although interest rates declined sharply beginning in late 1982, reducing or eliminating the negative interest rate spread problem, many institutions have been adversely affected by substantial losses on their loans and investments. These losses have been further compounded by the severe economic downturn in the Southwest. Between the end of 1982 and 1986, the number of insolvent thrifts as measured by generally accepted accounting principles more than doubled from about 220 to 460.

In 1987, the industry's financial condition continued to deteriorate. The 3,147 FSLIC-insured savings and loan institutions reported an overall net loss of $6.8 billion. Although nearly two-thirds of these institutions operated profitably, earning $6.6 billion during the year, those profits were far outweighed by the $13.4 billion in losses incurred by the remaining one-third of the institutions, located primarily in the Southwest. In 1987, the number of insolvent institutions further increased to 505, with reported negative net worth of $18 billion.

THE CORPORATION'S FINANCIAL CONDITION

The deterioration of the industry's financial condition has overwhelmed the resources the Corporation had accumulated to protect depositors. At the end of 1980, the Corporation had reserves of $6.5 billion, representing 1.35 percent of

total insured deposits; at December 31, 1987, it had a deficit of $13.7 billion. Due to increasing costs related to insurance actions, the Corporation began incurring losses in 1984. The Corporation's 1987 loss of $8.6 billion was primarily due to the $3.5 billion in costs related to institutions that have closed or received assistance and to the $6.9 billion increase in its liability for failed but still operating institutions.

The accompanying financial statements reflect a $17.4 billion liability for the expected costs of resolving the problems of the more than 200 hopelessly insolvent institutions for which the Corporation had assumed responsibility as of December 31, 1987, as well as several other institutions whose problems the Corporation expects to resolve in 1988. Because of the thrift industry's continuing difficulties, the Corporation has had to accept responsibility for increasing numbers of savings and loan institutions needing financial assistance. At the same time, its own weakened financial condition has prevented it from taking prompt action to liquidate or assist troubled institutions. As a result, a significant number of the failed but still operating institutions that were in the

Corporation's 1986 caseload were still in its 1987 caseload. In 1986, the Corporation's caseload increased from 93 institutions to 183. During 1987, its caseload further increased to 205. These 205 institutions reported total assets of $52.1 billion and negative tangible net worth of $14.6 billion at the end of 1987. In contrast, the 183 institutions in the Corporation's 1986 caseload reported total assets of $55.1 billion and negative tangible net worth of $8.2 billion.

The $17.4 billion liability at December 31, 1987, is not a projection of the cost to resolve all known problems in the industry. Instead, as previously noted, it is primarily the estimated cost to resolve the problems of those insolvent institutions for which the Corporation had assumed responsibility. At December 31, 1987, almost 300 additional institutions with assets of about $88 billion were insolvent using generally accepted accounting principles, exposing the Corporation to further risk.

A precise estimate of the eventual cost to resolve the problems of the 300 additional institutions cannot presently be made because the cost depends upon various uncertainties, such as the quality of each institution's assets, future interest rates, and the economic outlook for certain sectors of the economy in which many of the troubled institutions operate. The Corporation believes that the negative tangible net worth of those institutions indicates that the cost to resolve the problems of the additional 300 institutions will be at least $5.3 billion. We believe that this estimate may substantially understate the magnitude of financial assistance the institutions will need.

We expect these institutions, which have been incurring losses and which the Corporation probably will not act on for several years, to incur future operating losses, thus increasing the eventual costs the Corporation must absorb. In addition, the historical costs of resolving institutions' problems have consistently exceeded the reported negative tangible net worth of those institutions. Over the last 3 years, liquidating and merging institutions cost the Corporation more than 20 percent of an institution's assets and generally exceeded negative tangible net worth by almost 70 percent. Our estimates of the Corporation's ultimate cost to deal with these additional institutions, using historical factors, would indicate that the potential cost for the 300 additional institutions could be substantially in excess of the currently reported $5.3 billion negative tangible net worth, and range from $9 to $19 billion.

OUTLOOK FOR THE CORPORATION

Our opinion on the Corporation's 1986 financial statements, dated May 1, 1987, was qualified as subject to the Corporation "obtaining sufficient funds to continue operating and to meet its obligations." On August 10, 1987, the Congress passed the Competitive Equality Banking Act of 1987 which provides for recapitalizing the Corporation through the sale of a maximum of $10.8 billion in bonds over a 3 to 10 year period. The bonds will be repaid by the proceeds from zero coupon securities purchased with Federal Home Loan Bank funds, while the interest will be paid using a substantial portion of the next 30 years' insurance premiums the Corporation would otherwise receive.

Over the next 10 years, the Corporation expects to have about $28 billion in net new funds from regular assessments, special assessments, and the sale of bonds authorized by the Competitive Equality Banking Act of 1987, as well as the sale of assets from existing receiverships available for resolutions. Although this amount covers the current estimated cost related to the Corporation's 1987 caseload, depending upon the outcome of various uncertainties, it probably will not be adequate to resolve the problems of the additional 300 troubled institutions or to address any future problems in the industry.

In estimating its funds available for resolution, the Corporation has assumed that:

-- The amount of FSLIC-insured deposits will grow by more than 7 percent each year. While this assumption is consistent with overall growth during the last 10 years, it exceeds the growth rate over the last 3 years. Further, this assumption implies that no significant number of institutions will leave the FSLIC system in spite of the planned expiration in August 1988 of the moratorium on exits from the system. This assumption further implies that other financial institutions are not able to take away any substantial portion of the thrift industry's current business.

- -- It will continue the special assessment of 1/8 of 1 percent of insured deposits throughout the next 10 years.

- -- Recapitalization bonds will continue to be marketed at interest rates of slightly less than 10 percent.

We believe that these assumptions are relatively optimistic and, as with any projection, may prove incorrect. An adverse change in any of these assumptions will reduce the Corporation's available funds and affect its ability to resolve the industry's problems.

In determining the costs related to its caseload, the Corporation has assumed that:

- -- It can minimize its resolution costs by selling or merging substantially all institutions rather than liquidating them since liquidations are almost invariably more expensive than mergers. However, over the last 5 years, more than one-third of the Corporation's resolutions were liquidations.

- -- It can act on most of the problem institutions in the next 2 years, thus, minimizing those institutions' additional losses and the cost to the Corporation. Since assistance agreements usually contain provisions requiring the Corporation to, as a minimum, compensate the acquirer for the negative net worth of the troubled institutions, allowing institutions to continue operating and incur additional losses would increase the Corporation's resolution costs.

- -- Interest rates will remain favorable and will not increase to any significant extent. Any significant increase in costs of funds to the thrift industry could again exacerbate the financial pressures on the industry and cause additional deterioration in capital and profitability.

-- Virtually no new problem cases will develop in the industry over the next 10 years and no further resolution costs will be incurred beyond those currently identified.

Finally, while it was initially contemplated, both in originally establishing the Corporation and in recapitalizing it in 1987, that the industry would be able to provide the funds needed to resolve its problems, the deteriorated capital position and poor operating results of a large segment of the industry seriously impair the industry's ability to do so. In this regard, the deterioration has continued up to the present--in the first quarter of 1988, the industry reported further capital losses of $3.3 billion.

GAO OPINION

As a result of the above conditions, namely,

-- the magnitude of the resolution costs for currently insolvent institutions,

-- the uncertainties about the Corporation's future revenue streams,

-- the Corporation's current $13.7 billion deficit, and

-- the industry's deteriorated financial condition,

we believe that further congressional action, beyond that already taken under the Competitive Equality Banking Act of 1987 to recapitalize the Corporation, may well be needed to enable the Corporation to continue to meet its obligations and provide the deposit insurance it is mandated to provide.

In our opinion, subject to the potential need for further congressional action to enable the Corporation to resolve the industry's problems and meet its obligations, the financial statements referred to above present fairly the financial position of the Federal Savings and Loan Insurance Corporation as of December 31, 1987 and 1986, and the results of its operations and changes in financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
SUMMARY CONSOLIDATED STATEMENT OF FINANCIAL CONDITION

SETS	1987	1986
Cash and investments	$ 3,400,000,000	$ 4,100,000,000
Claims against assets of closed institutions (net)	4,900,000,000	3,800,000,000
Loans and assistance to insured institutions	2,200,000,000	3,000,000,000
TOTAL ASSETS	$ 10,500,000,000	$ 10,900,000,000
ABILITIES		
Accounts payable and other liabilities	$ 100,000,000	$ -0-
Notes and interest payable to insured institutions	5,100,000,000	5,000,000,000
Notes payable to Federal Home Loan Banks	900,000,000	900,000,000
Estimated losses under existing agreements with acquirors	700,000,000	800,000,000
Liability for losses on unresolved cases	17,400,000,000	10,500,000,000
TOTAL LIABILITIES	24,200,000,000	17,200,000,000
SURANCE FUND RESERVE (DEFICIT)		
Recapitalization funds	1,200,000,000	-0-
Primary reserve	(14,900,000,000)	$(6,300,000,000)
TOTAL RESERVE (DEFICIT)	$(13,700,000,000)	$(6,300,000,000)

The **Chairman**. Thank you very much, Mr. Wolf.

Our next witness is William Ferguson, of Ferguson and Company. You have a very impressive analysis, Mr. Ferguson. You're certainly from a crucial part of the country with respect to S&L's. Go right ahead, sir.

STATEMENT OF WILLIAM C. FERGUSON, CEO, FERGUSON AND COMPANY, IRVING, TX

Mr. **Ferguson**. Thank you, Mr. Chairman.

I will briefly summarize the salient points of my statement and my concluding comments. In the interest of time I will omit the first two paragraphs pertaining to the sources of information and discuss the issue of capital adequacy.

CAPITAL ADEQUACY

A financial institution does not need capital in order to exist or to generate net income. As a financial intermediary, the major activities of a thrift involves the purchase of money and the resale of such money at a profit. Therefore, the composition of a thrift's balance sheet has more impact on its earning power than does the amount of its capital, regardless of the basis used in measuring such capital. For example, the higher the ratio of interest-earning assets to interest-bearing liabilities, the more likelihood that a thrift can generate net income. Conversely, the lower this ratio becomes the more difficult it is for the thrift to generate net income.

In an industry with sound management and an effective regulatory and supervisory structure, minimum capital requirements mandated by thrift regulators should be adequate to provide assurance that if a thrift experiences unforeseen losses, a cushion exists to protect the Federal Savings and Loan Insurance Corporation from having to cover those losses. In other words, capital is the last line of defense for the Federal deposit insurance agencies.

CURRENT PERFORMANCE OF THE INDUSTRY

As for the current performance of the industry, the industry had a dismal performance in 1987 and reported a net loss in the amount of approximately $6.3 billion. However, several factors had a negative impact on the industry during 1987. For instance, during the early part of the year, the thrift industry was directed to write off approximately $800 million receivable from the FSLIC secondary reserve. The industry felt the impact of tax law changes which took away many of the benefits enjoyed by real estate syndicators, developers and investors. Regional economies in certain areas of the U.S. continued to deteriorate, resulting in losses or provisions for losses on assets totaling almost $8.2 billion.

In spite of the poor performance reported by the thrift industry during 1987, a substantial portion of the industry was profitable, probably has an adequate level of capital, and is forecasted to generate a positive net operating income during the next 3 years. Therefore, the industry can be analyzed by dividing its members into two distinct segments—I call them the "haves" and the "have nots."

Let's discuss the "haves." At December 31, 1987, 2,634 thrift institutions had positive GAAP capital. This group accounted for 84 percent of the total number of institutions and 89 percent of the assets.

This group of thrifts reported net income of over $3.7 billion in 1987. Its GAAP capital as a percentage of total assets has increased each year since 1984 and its return on average assets showed an increase in both 1985 and 1986 but dropped significantly in 1987. However, a key ratio, interest-earning assets to interest-bearing liabilities increased in 1985 and 1986 and dropped only slightly in 1987.

However, there's a negative side to the "haves." We call it the "haves" watch list. In spite of positive capital ratios reported by the GAAP solvent thrifts, a further analysis of this group is necessary. Included in this group are 169 thrifts that have a ratio of interest-earning assets to interest-bearing liabilities of less than 90 percent. It becomes increasingly difficult for a thrift to generate net operating income as that key ratio declines. This group represents 5 percent of the total number of institutions and 9 percent of the assets of all thrift institutions.

While the thrifts discussed in the preceding paragraph pose no immediate threat to the FSLIC fund, public policy considerations seem to dictate that they be encouraged to recapitalize themselves, change their operational strategies or seek a well capitalized merger partner.

Now let's look at the "have nots." At December 31, 1987, 507 thrift institutions had negative GAAP capital. This group accounted for 16 percent of the total number of institutions and 11 percent of the assets.

There are also some "have nots" that could potentially be rehabilitated. In spite of the generally poor financial condition of the GAAP negative thrifts, a further analysis is necessary and included in this group are 131 institutions that have a ratio of interest-earning assets to interest-bearing liabilities greater than 90 percent. This group accounted for 4 percent of the total number of thrifts and 2 percent of the assets.

These thrifts do pose a potential threat to the FSLIC fund and public policy considerations would seem to dictate the same actions as required for the weak GAAP solvent thrifts.

However, it is questionable that these thrifts pose any more threat to the FSLIC than those GAAP solvent thrifts with a ratio of interest-earning assets to interest-bearing liabilities of less than 90 percent. In fact, they may actually pose less risk.

LOCATION OF PROBLEM INSTITUTIONS

Next, let's look at the location of the problem institutions which is set forth in my full report. When considering the condition of the thrift industry, it seems to be widely believed that most of the existing problems in the industry are in Texas. An analysis set forth in the full report clearly demonstrates that substantial problems also exist in thrifts located outside of Texas. While the total assets in Texas constitute only 32 percent of the total assets of GAAP insolvent thrifts, the negative GAAP capital in Texas constitutes 48 percent of the total negative GAAP capital of all GAAP insolvent institutions. And, because of the severe economic problems which currently exist in Texas, these percentages could increase.

In the interest of brevity, I'm going to omit the discussion concerning the causes of current problems which is contained in paragraphs 13 and 14, and go over to the outlook for the future.

OUTLOOK FOR THE VIABLE PORTION OF THE INDUSTRY

A detailed forecast for the viable portion of the thrift industry is very difficult to quantify and, to a considerable extent, is closely linked to the disposition of the current insolvent thrifts. Continued publicity concerning the problems of the thrift industry and the FSLIC has been very injurious to solvent thrifts and has driven up the rates this group has to pay for savings deposits and other borrowings. Also, the cost of funds for all solvent thrifts is being driven up because they are forced to compete with the liquidity requirements of insolvent thrifts. The disposition of the large number of insolvent thrifts will tend to make this differential disappear or become smaller and enhance the profitability of the industry as a whole.

In the interest of time I'd like to skip over to paragraph No. 19, which contains my concluding comments.

Assuming a relatively stable interest rate environment, generally good overall economic conditions, a slow but steady recovery of economically depressed regions and an improved system of regulation and supervision, the outlook for the overall industry is quite favorable.

However, it should be clear that continuing to defer a comprehensive attack on the problems of the financial institutions industry not only increases the ultimate cost of resolution, but also may call into question the safety and soundness of the entire financial system.

Unless an accelerated system for dealing with the massive number of insolvent thrifts is developed quickly, the FSLIC will drop further behind in dealing with problem institutions. It should be apparent from the forecasted financial statements included in my full report that there are an additional number of thrifts likely to become insolvent within the foreseeable future and corrective action should be taken now to minimize the psychological impact on financial markets as well as financial costs to the Government.

There is no doubt in my mind that the resources available to the FSLIC will be inadequate to dispose of the insolvent thrifts. Also, there is still not a clear picture of what the cost will be to resolve the problems of institutions insured by the Federal Deposit Insurance Corporation. There are indications that problem assets and problem institutions in the banking industry could easily match or exceed the present resources of the FDIC creating more uncertainty and instability in financial markets.

Consequently, the next President of the United States and Congress will again have to wrestle with the subject of the adequacy of our present deposit insurance system for all types of financial institutions. In the meantime, it seems appropriate for Congress in coordination with the administration to take whatever steps are necessary to reassure the world financial markets that the full faith and credit of the U.S. Government does in fact stand behind the insurance funds. This would substantially reduce the cost of funds for many, if not the majority, of financial institutions and restore to profitability many marginally profitable institutions, both in the banking and thrift industries.

Thank you very much and I'll be happy to answer any questions.

[The complete prepared statement of Mr. Ferguson follows:]

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
SUMMARY CONSOLIDATED STATEMENT OF INCOME AND EXPENSES

INCOME	1987	1986
Insurance premiums	$ 700,000,000	$ 700,000,000
Special assessment premiums	1,100,000,000	1,100,000,000
Interest income	400,000,000	500,000,000
Other income	200,000,000	100,000,000
TOTAL INCOME	2,400,000,000	2,400,000,000
EXPENSES		
Administrative and related expenses	300,000,000	100,000,000
Interest expense	300,000,000	300,000,000
Provision for losses related to claims against assets of closed institutions	1,800,000,000	2,900,000,000
Provision for losses related to acquisitions and mergers	1,700,000,000	1,100,000,000
Provision for losses related to unresolved cases	6,900,000,000	8,900,000,000
TOTAL EXPENSES	11,000,000,000	13,300,000,000
NET LOSS FROM OPERATIONS	$(8,600,000,000)	$(10,900,000,000)

Summary Statement

William C. Ferguson
Committee on Banking, Housing, and Urban Affairs
United States Senate
May 19, 1988

Mr. Chairman, I am William Ferguson, Chairman of Ferguson & Company, a financial institutions consulting firm headquartered in Irving, Texas.

I will briefly summarize the salient points of my statement and the concluding comments.

Sources of Information

1) All financial information presented was derived using computer tapes purchased from the Federal Home Loan Bank Board ("FHLBB"). The selected financial information, historical financial statements and forecasted financial statements were prepared using the Thrift Analysis and Forecasting System ("TAFS"tm), a micro computer software system developed by Ferguson & Company.

2) For the financial analysis presented, the industry is divided into groups which have positive estimated capital as determined in accordance with generally accepted accounting principles ("GAAP") and groups which have negative estimated GAAP capital. GAAP is defined as "estimated" because certain adjustments are necessary to convert from capital as determined under regulatory accounting principles ("RAP") to GAAP capital. All of these adjustments cannot be determined from an examination of the periodic financial reports filed by thrifts with the FHLBB. Currently, thrifts are permitted to file their financial reports with the FHLBB using either RAP or GAAP.

Capital Adequacy

3) A financial institution does not need capital in order to exist or to generate net income. As a financial intermediary, the major activities of a thrift involves the purchase of money and the resale of such money at a profit. Therefore, the composition of a thrifts' balance sheet has more impact on its earning power than does the amount of its capital, regardless of the basis used in measuring such capital. For example, the higher the ratio of interest-earning assets to interest-bearing liabilities, the more likelihood that a thrift can generate net income. Conversely, the lower this ratio becomes the more difficult it is for a thrift to generate net income.

4) In an industry with sound management and an effective regulatory and supervisory structure, minimum capital requirements mandated by thrift regulators should be adequate to provide assurance that if a thrift experiences unforeseen losses, a cushion exists to protect the Federal Savings and Loan Insurance Corporation ("FSLIC") from having to cover those losses. In other words, capital is the last line of defense for the federal deposit insurance agencies.

Current Performance

5) The industry had a dismal performance in 1987 and reported a net loss in the amount of $6.3 billion. However, several factors had a negative impact on the industry during 1987. During the early part of 1987, the thrift industry was directed to write-off approximately $800 million receivable from the FSLIC secondary reserve. The industry felt the impact of tax law changes which took away many of the benefits enjoyed by real estate syndicators, developers and investors. Regional economies in certain areas of the U.S. continued to deteriorate, resulting in losses or provisions for losses on assets totaling almost $8.2 billion.

In spite of the poor performance reported by the thrift industry during 1987, a substantial portion of the industry was profitable, probably has an adequate level of capital and is forecasted to generate a positive net operating income during the next three years. Therefore, the industry can be analyzed by dividing its members into two distinct segments: the "haves" and the "have nots."

The "Haves"

6) At December 31, 1987, 2,634 thrift institutions had positive GAAP capital. This group accounted for 84% of the total number of institutions and 89% of the assets. Exhibit III lists the geographical dispersion of these thrifts and Exhibit IV lists aggregate financial highlights and historical financial statements.

This group of thrifts reported net income of over $3.7 billion in 1987. Its GAAP capital as a percentage of total assets has increased each year since 1984 and its return on average assets showed an increase in both 1985 and 1986 but dropped significantly in 1987. However, a key ratio, interest-earning assets to interest-bearing liabilities increased in 1985 and 1986 and dropped only slightly in 1987.

The "Haves" Watch List

7) In spite of capital ratios reported by the GAAP solvent thrifts, a further analysis of this group is necessary. Included

in this group are 169 thrifts that have a ratio of interest-earning assets to interest-bearing liabilities of less than 90%. It becomes increasingly difficult for a thrift to generate net operating income as that key ratio declines. This group represents five percent of the total number of institutions and nine percent of the assets of all thrift institutions.

8) While the thrifts discussed in the preceding paragraph pose no immediate threat to the FSLIC fund, public policy considerations seem to dictate that they be encouraged to recapitalize themselves, change their operational strategies or seek a well capitalized merger partner.

The "Have Nots"

9) At December 31, 1987, 507 thrift institutions had negative GAAP capital. This group accounted for 16% of the total number of institutions and 11% of the assets. Exhibit IX lists the geographical dispersion of these thrifts and Exhibit X lists aggregate financial highlights and historical financial statements. This group reported a net loss in excess of $10 billion for 1987.

The "Have Nots" That Are Potential "Haves"

10) In spite of the generally poor financial condition of the GAAP negative thrifts, a further analysis of this group is necessary. Included in this group are 131 institutions that have a ratio of interest-earning assets to interest-bearing liabilities greater than 90%. This group accounted for four percent of the total number of thrifts and two percent of the assets. Exhibit XII shows the geographical dispersion of these thrifts and Exhibit XIII shows the aggregate financial highlights and historical financial statements. While this group is insolvent when measured by GAAP standards, it may be possible for these thrifts to generate net operating income.

11) These thrifts may pose a potential threat to the FSLIC fund and public policy considerations would seem to dictate the same actions as required for the weak GAAP solvent thrifts discussed in sections 7 and 8 above.

However, it is questionable that these thrifts pose any more threat to the FSLIC than those GAAP solvent thrifts with a ratio of interest-earning assets to interest-bearing liabilities of less than 90%. In fact, they may actually pose less risk.

Location of Problem Institutions

12) When considering the condition of the thrift industry, it seems to be widely believed that most of the existing problems in the industry are in Texas. An analysis of Exhibit IX clearly

demonstrates that substantial problems also exist in thrifts located outside of Texas. While the total assets in Texas constitute only 32% of the total assets of GAAP insolvent thrifts, the negative GAAP capital in Texas constitutes 48% of the total negative GAAP capital of all GAAP insolvent institutions. However, because of the severe economic problems which currently exist in Texas, these percentages could increase.

Causes of Current Problems

13) It is not reasonable to blame only the thrift industry for the problems which were created during the years following deregulation. While the industry was aggressively taking advantage of its new asset powers, few changes were taking place in the supervisory arena. The examination and supervisory functions at that time were separated, with the examination staff being employees of the FHLBB. The FHLBB was operating under severe budgetary and salary restraints and was unable to attract and retain an adequate staff of qualified examiners to cope with the growing list of fast-growth problem thrifts. Very quickly, the industry was changing from one that was relatively simple to one that was becoming fast-paced and increasingly complex. The supervision function was carried out by each of the twelve Federal Home Loan Banks. All in all, it was a cumbersome system that did not respond quickly to crisis resolution. The examination function was transferred to the district banks in mid-1985 but, by then, the situation was out of control.

14) When the examination function was transferred to the individual Federal Home Loan Banks, the budgetary and salary restraints were substantially alleviated. Subsequent to the transfer, it appears that substantial progress has been made in attracting quality examiners, some of whom have been recruited from the federal banking agencies. In addition, a substantial effort has been made to develop and implement high-quality training programs. However, because of the rapid growth in numbers of examination personnel, it will take several years to build a staff with heavy examination experience.

OUTLOOK FOR THE VIABLE PORTION OF THE INDUSTRY

15) A detailed forecast for the viable portion of the thrift industry is very difficult to quantify and, to a considerable extent, is closely linked to the disposition of the current insolvent thrifts. Continued publicity concerning the problems of the thrift industry and the FSLIC has been very injurious to solvent thrifts and has driven up the rates this group has to pay for savings deposits and other borrowings. Also, the cost of funds for all solvent thrifts is being driven up because they are forced to compete with the liquidity requirements of insolvent thrifts. The disposition of the large number of insolvent thrifts will tend to make this differential disappear or become smaller and enhance the profitability of the industry as a whole.

16) In a world of electronic technology, high speed communications and the breakdown of legal and regulatory barriers to interstate banking, an efficient and effective financial system will require a far smaller number of financial institutions. In short, we are an "overbanked" nation with too many financial institutions and branches. A substantial consolidation of the current number of financial institutions, both thrifts and commercial banks, should help to improve the long term viability of the industry.

17) Finally, the viability of the industry is largely dependent upon the strength of the U.S. economy, the level of interest rates and the strength of the real estate sector of the economy. However, because a substantial percentage of the assets of the industry is located in regional areas where the economy is considered depressed, the outlook is also partially dependent upon the economic recovery of those regional areas.

ABILITY OF THE REGULATORY SYSTEM TO DEAL WITH THE PROBLEMS

18) Because of the number of insolvencies which currently exist in the thrift industry and the budgetary and salary restraints under which the FHLBB has operated in the past, it is difficult to assess the ability of the regulators to deal with the problems that exist today. While almost no one will dispute the observation that massive problems remain unresolved today, few close observers of the FHLBB will dispute the fact that the agency simply has operated under budgetary restrictions that precluded it from building and staffing the organization with the resources necessary to deal with the challenges of deregulation and the rapid growth of the industry. Therefore, even if provided the resources today, the FHLBB still would have a huge backlog of cases to resolve and the job is too massive to complete overnight.

CONCLUDING COMMENTS

19) Assuming a relatively stable interest rate environment, generally good overall economic conditions, a slow but steady recovery of economically depressed regions and an improved system of regulation and supervision the outlook for the overall industry is quite favorable.

20) However, it should be clear that continuing to defer a comprehensive attack on the problems of the financial institutions industry not only increases the ultimate cost of resolution, but also may call into question the safety and soundness of the entire financial system.

21) Unless an accelerated system for dealing with the massive number of insolvent thrifts is developed quickly, the FSLIC will drop further behind in dealing with problem institutions. It should be apparent from the forecasted financial statements included throughout this presentation that there are an additional number of thrifts likely to become insolvent within the foreseeable future and corrective action should be taken now to minimize the psychological impact on financial markets as well as financial costs to the government.

22) There is no doubt in my mind that the resources available to the FSLIC will be inadequate to dispose of the insolvent thrifts. Also, there is still not a clear picture of what the cost will be to resolve the problems of institutions insured by the Federal Deposit Insurance Corporation ("FDIC"). There are indications that problem assets and problem institutions in the banking industry could easily match or exceed the present resources of the FDIC creating more uncertainty and instability in financial markets.

24) Consequently, the next President of the United States and Congress will again have to wrestle with the subject of the adequacy of our present deposit insurance system for all types of financial institutions. In the meantime, it seems appropriate for Congress in coordination with the Administration to take whatever steps are necessary to reassure the world financial markets that the full faith and credit of the U. S. Government does stand behind the insurance funds. This would substantially reduce the cost of funds for many, if not the majority of financial institutions and restore to profitability many marginally profitable institutions, both in the banking and thrift industries.

PRESENTATION TO THE
SENATE COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS

MAY 19, 1988

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CHAIRMAN & CHIEF EXECUTIVE OFFICER

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STATE OF THE THRIFT INDUSTRY

INTRODUCTION

This presentation explores the overall condition of the thrift industry, provides an assessment of the causes of its current difficulties, discusses the outlook for the viable portion of the industry and discusses the ability of the regulatory system to deal with industry problems.

Only thrifts insured by the FSLIC are included in this presentation. All financial information presented was derived using computer tapes purchased from the Federal Home Loan Bank Board ("FHLBB"). Such tapes contain final financial information through June 30, 1987 and preliminary financial information for periods after June 30, 1987. Since amended reports may be filed by thrifts after preliminary tapes are released by the FHLBB, the financial information included in this presentation may differ somewhat from information prepared by the FHLBB for other forums. However, such differences are not expected to be significant enough to affect the validity of the analysis or conclusions reached in this presentation. The selected financial information, historical financial statements and forecasted financial statements were prepared using the Thrift Analysis and Forecasting System ("TAFS"tm), a micro computer software system developed by Ferguson & Company.

For the financial analysis presented, the industry is divided into groups which have positive estimated capital as determined in accordance with generally accepted accounting principles ("GAAP") and groups which have negative estimated GAAP capital. GAAP is defined as "estimated" because certain adjustments are necessary to convert from capital as determined under regulatory accounting principles ("RAP") to GAAP capital. All of these adjustments cannot be determined from an examination of the periodic financial reports filed by thrifts with the FHLBB. Currently, thrifts are permitted to file their financial reports with the FHLBB using either RAP or GAAP.

Under current FHLBB regulations, as required by the Competitive Equality Banking Act of 1987 ("CEBA"), the thrift industry will generally be required to convert to GAAP for purposes of all financial reporting on January 1, 1989. The use of GAAP for such reporting will facilitate the analysis of the industry's financial condition and results of operations and should enable the financial statements reported by one thrift institution to be comparable with financial statements reported by any other thrift institution. For this reason, GAAP has been used in the financial analysis included in this presentation.

Theoretically, a financial institution does not need capital in order to exist or to generate net income. As a financial intermediary, the major activities of a thrift involves the purchase of money and the resale of such money at a profit. Therefore, the composition of a thrifts' balance sheet has more impact on its earning power than does the amount of its capital, regardless of the basis used in measuring such capital. For example, the higher the ratio of interest-earning assets to interest-bearing liabilities, the more likelihood that a thrift can generate net income. Conversely, the lower this ratio becomes the more difficult it is for a thrift to generate net income. This simple analysis, of course, assumes that the thrift has a reasonable interest margin between its interest-earning assets and interest-bearing liabilities, a reasonably stable interest rate environment exists, its expenses fall within acceptable limits and credit risk, i.e. uncollectible loans, is small.

Therefore, in an industry with sound management and an effective regulatory and supervisory structure, minimum capital requirements mandated by thrift regulators should be adequate to provide assurance that if a thrift experiences unforeseen losses, a cushion exists to protect the Federal Savings and Loan Insurance Corporation ("FSLIC") from having to cover those losses.

Forecasted financial statements are presented throughout this analysis for various segments of the thrift industry. These forecasted statements do not attempt to project elements of non-operating income and non-operating expenses, except for amortization of loan losses, because such elements are almost impossible to forecast based upon available historical information.

OVERVIEW OF THE INDUSTRY

At December 31, 1987, the 3,141 thrifts insured by the FSLIC had total assets of over $1.2 trillion. Exhibit I shows the geographical dispersion of these thrifts and Exhibit II presents aggregate financial highlights and historical financial statements.

The industry had a dismal performance in 1987 and reported a net loss in the amount of $6.3 billion. Moreover, estimated GAAP capital as a percentage of total assets decreased to its lowest point in several years as did the ratio of interest-earning assets to interest-bearing liabilities. However, several factors had a negative impact on the industry during 1987. During the early part of 1987, the thrift industry was directed to write-off approximately $800 million receivable from the FSLIC secondary reserve. The industry felt the impact of tax law changes which took away many of the benefits enjoyed by real estate syndicators, developers and investors. Regional economies in certain areas of the U.S. continued to deteriorate, resulting in provisions for losses on assets totaling almost $8.2 billion. Finally, little progress was made in resolving the growing FSLIC caseload of insolvent thrifts and the net losses of these thrifts continued to accumulate. It is widely recognized that the funding needs of these insolvent thrifts have a substantial impact on the cost of funds of solvent thrifts as well as on commercial banks.

In spite of the poor performance reported by the thrift industry during 1987, a substantial portion of the industry was profitable, probably has an adequate level of capital and is forecasted to generate a positive net operating income during the next three years. Therefore, the industry can be analyzed by dividing its members into two distinct segments; the "haves" and the "have nots."

The "Haves"

At December 31, 1987, 2,634 thrift institutions had positive GAAP capital. This group accounted for 84% of the total number of institutions and 89% of the assets. Exhibit III lists the geographical dispersion of these thrifts and Exhibit IV lists aggregate financial highlights and historical financial statements.

This group of thrifts reported net income of over $3.7 billion in 1987, a reduction of 45.18% from 1986. Its GAAP capital as a percentage of total assets has increased each year since 1984 and its return on average assets showed an increase in both 1985 and 1986 but dropped significantly in 1987. However, a key ratio, interest-earning assets to interest-bearing liabilities increased in 1985 and 1986 and dropped only slightly in 1987. The net interest income for this group, expressed as a percentage of average assets, increased for the fourth straight year.

Forecasted financial statements and related projection assumptions for these thrifts, along with comparative historical financial statements, are included in Exhibit V. A five percent growth rate and a stable interest rate environment is assumed. Of course, other assumptions would produce different results. Asset and liability maturity information is not released by the FHLBB to vendors who purchase industry financial information so it is not possible to evaluate the extent to which the industry is subject to interest rate risk. However, most analysts believe that any significant increase in interest rates would have a devastating effect on the capital position of the industry.

Net operating income, expressed as a percentage of average assets, is expected to grow during each of the three years covered by the projection period. Also, the ratio of interest-earning assets to interest- bearing liabilities is projected to continue to increase as well as the level of GAAP capital. However, many of the thrifts included in this group are located in areas of the U.S. that have experienced an oversupply of commercial and residential real estate and have seen a substantial deterioration of real estate values. Therefore, if deterioration of property values in these areas continues, the viability of thrifts located in these areas could be threatened. Also, the possibility always exists that adequate loss reserves have not been provided by thrifts located in these economically depressed areas or by thrifts in other areas who have purchased whole loans or participations originated in these areas. If adequate loss reserves have not been provided, the capital levels reported could prove to be illusory.

The "Haves" Watch List

In spite of capital ratios reported by the GAAP solvent thrifts, a further analysis of this group is necessary. Included in this group are 169 thrifts that have a ratio of interest-earning assets to interest-bearing liabilities of less than 90%. It becomes increasingly difficult for a thrift to generate net operating income as that key ratio declines. This group represents five percent of the total number of institutions and nine percent of the assets of all thrift institutions. Exhibit VI shows the geographical dispersion of these thrifts and Exhibit VII shows the aggregate financial highlights and historical financial statements. This group has a GAAP capital to total assets ratio of 3.19% as compared to 4.91% for all solvent thrifts, or 35.03% less. Its net interest income expressed as a percentage of average assets was only .83% as compared to 1.93% for all solvent thrifts. Also, its operating expenses expressed as a percentage of average assets was 2.22% as compared to 1.94% for all solvent thrifts.

Forecasted financial statements and the related projection assumptions for these thrifts, along with comparative historical financial statements, are included in Exhibit VIII. Inasmuch as this group will be under pressure to increase its capital ratios, liabilities were projected to remain constant. However, one can see from the Historical & Forecasted Balance Sheets presented that liabilities in the forecasted scenario did, in fact, grow. This growth occurred because these thrifts are, as a group, projected to continue experiencing net operating losses with the result that additional liabilities will be incurred to cover cash flow shortfalls and to maintain regulatory mandated liquidity levels. Obviously, the level of GAAP capital will continue to deteriorate. Throughout the projection period, the ratio of interest-earning assets to interest-bearing liabilities continues to deteriorate. Inasmuch as many of the thrifts in this group are located in economic areas of the country that are considered to currently be depressed, the deterioration of these thrifts could occur much faster than projected if property values continue to deteriorate or if repossession of real estate continues at the current pace.

While the thrifts discussed in the preceding paragraph pose no immediate threat to the FSLIC fund, public policy considerations seem to dictate that they be encouraged to recapitalize themselves, change their operational strategies or seek a well capitalized merger partner. In the event these actions cannot be accomplished voluntarily, the FSLIC should be

prepared to seek its own solution before thrifts in this group deteriorate to the point where the FSLIC has to provide loss coverage to facilitate closures or mergers. Also, thrifts facing insolvency have the temptation to hit a "home run" in order to restore capital to acceptable levels. If a "strikeout" occurs, FSLIC is left to pick up the tab.

The "Have Nots"

At December 31, 1987, 507 thrift institutions had negative GAAP capital. This group accounted for 16% of the total number of institutions and 11% of the assets. Exhibit IX lists the geographical dispersion of these thrifts and Exhibit X lists aggregate financial highlights and historical financial statements.

This group of thrifts obviously pose a grave danger to the solvency of the FSLIC fund. Its GAAP capital deficit, both as a percentage of total assets and dollar amount, has increased every year since 1984 and its net operating losses have continued to increase for each of the years presented. Its ratio of interest-earning assets to interest-bearing liabilities has also decreased each year since 1984. The yield/cost spread for this group was only 1.32% as compared to 2.35% for all GAAP solvent thrifts. This is because the insolvent thrifts have a lower yield on earning assets and a higher cost of funds than do the solvent thrifts. The insolvent thrifts experienced a deficit net interest income, expressed as a percentage of average assets, of .71% while all solvent institutions experienced a positive net interest income of 1.93%. Additionally, operating expenses, expressed as a percentage of average assets, was 2.48% for the insolvent thrifts as compared to 1.94% for the solvent thrifts.

Forecasted financial statements and the related projection assumptions for these thrifts, along with the comparative historical financial statements, are included in Exhibit XI. This group will be under extreme regulatory pressure to curtail liability growth. However, inasmuch as insolvent financial institutions generally are under liquidity pressures, it can be seen from the Historical & Forecasted Balance Sheets presented that liabilities in the forecasted scenario continue to grow significantly. Again, this growth is necessary because this group will not have the liquidity to fund their net operating losses and will be forced to attract new deposits in order to do so. Also, in the projection scenario, additional service corporation losses are not projected. However, inasmuch as a substantial portion of service corporation activity in thrifts is related to real estate development activities, this assumption may not be reasonable. Net operating losses, expressed as a percentage of average assets, are projected to increase during each of the three years covered by the forecasted statements. Also, the ratio of interest-earning assets to interest-bearing liabilities is projected to continue to decrease. Finally, to the extent that adequate loan loss reserves have not been provided, the actual operating losses experienced by these institutions could be considerably worse than projected. Obviously, the FSLIC must either close or otherwise dispose of these institutions as quickly as possible.

The "Have Nots" That Are Potential "Haves"

In spite of the poor condition of the GAAP negative thrifts, a further analysis of this group is necessary. Included in this group are 131 institutions that have a ratio of interest-earning assets to interest-bearing liabilities greater than 90%. This group accounted for four percent of the total number of thrifts and two percent of the assets. Exhibit XII shows the geographical dispersion of these thrifts and Exhibit XIII shows the aggregate financial highlights and historical financial statements. The ratio of their GAAP capital deficit to total assets is 2.61% as compared to 13.36% for all GAAP insolvent thrifts. Their net interest income, expressed as a percentage of average assets, was a positive 1.49% as compared to a negative .71% for all insolvent thrifts. Also, the yield/cost spread for this group is 2.30% as compared to only 1.32% for all insolvents. Additionally, operating expenses for this group are significantly lower than for all insolvent institutions. While this group is insolvent when measured by GAAP standards, it may be possible for these thrifts to generate net operating income.

Forecasted financial statements and the related projection assumptions for these thrifts, along with the comparative historical financial statements, are included in Exhibit XIV. This group is projected to generate a small net operating income. The liability growth requirement during each of the three years covered by the projection is small and the ratio of interest-earning assets to interest-bearing liabilities is projected to remain relatively constant. However, it should be noted that, inasmuch as many of the thrifts in this group are located in economic areas of the country that are considered to be economically depressed, they could deteriorate rapidly if property values continue to decrease and repossessions of real estate remain at current levels.

These thrifts pose a current threat to the FSLIC fund and public policy considerations would seem to dictate that these thrifts be encouraged immediately to recapitalize themselves, change their operational strategies or seek a well capitalized merger partner. In the event no voluntary resolution can be found, the FSLIC should be prepared to seek its own solution before the thrifts in this group deteriorate to the point where the FSLIC has to provide loss coverage. However, it is questionable that these thrifts pose any more threat to the FSLIC than those GAAP solvent thrifts with a ratio of interest-earning assets to interest-bearing liabilities of less than 90%. In fact, they may actually pose less risk.

Location of Problem Institutions

When considering the condition of the thrift industry, it seems to be widely believed that most of the existing problems in the industry are in Texas. An analysis of Exhibit IX clearly demonstrates that substantial problems exist in thrifts located outside of Texas. While the total assets in Texas constitute only 32% of the total assets of GAAP insolvent thrifts, the negative GAAP capital in Texas constitutes 48% of the total negative GAAP capital of all GAAP insolvent institutions. However, because of the severe economic problems which currently exist in Texas, these percentages could increase.

CAUSES OF THE CURRENT DIFFICULTIES

The current problems of the present thrift industry can be traced back to the 1930s. For several decades, the industry was able to successfully mismatch the maturities of its assets and liabilities. With only moderate inflation, the earnings of the industry generally were reasonably predictable. However, the fragility of the underpinnings of the industry quickly became painfully apparent in 1979 when interest rates soared and, very quickly, the industry was swimming in red ink. The industry experienced substantial disintermediation until the liability side of the balance sheet was eventually deregulated. By 1982, when federal institutions were given significant new asset powers, its capital had been severely reduced. During these years, several hundred thrift institutions were either closed or merged with healthier institutions. As a result of the assistance provided in connection with these closures or mergers, the resources of the FSLIC fund were substantially reduced.

With the new asset powers in hand, it appeared to many observers and to many industry leaders that the problems of the industry had been solved. Never again would the industry be locked into regulations which required that most of their investment activities be of a nature which would require a mismatch between the maturity of assets and liabilities. Along with the new asset powers granted by Congress, the FHLBB also provided new tools to thrifts to assist them in restructuring their balance sheets and rebuilding their net worth. These tools allowed the use of purchase accounting in mergers and acquisitions, deferral of loan losses incurred in connection with the disposition of low rate loan portfolios and the use of appraised equity capital. In addition, capital requirements were lowered.

For a short period of time, it appeared that the thrift industry was on the road to recovery. The industry attempted to take maximum advantage of its new asset powers and the more permissive regulations issued by the FHLBB. Many thrifts commenced marketing commercial real estate loans, commercial loans and consumer loans on a massive scale. Also, many thrifts formed real estate development companies and/or entered into joint venture arrangements with real estate developers. In order to rebuild their net interest income, many thrifts developed a strategy of rapid growth so as to dilute the percentage of its loan portfolios that were locked-in at low interest rates and/or had long maturities. The liabilities necessary to fund this rapid growth were obtained by offering rates higher than the competition, by the solicitation of brokered deposits or by setting up money-desk operations. Many thrifts did not have the expertise or grew too rapidly to use their investment powers wisely. The fast growing thrifts contributed substantially to the over-building and ultimate deterioration of certain regional economies, primarily in Texas and other parts of the southwest.

However, it is not reasonable to blame only the thrift industry for the problems which were created during the years following deregulation. While the industry was aggressively taking advantage of its new asset powers, few changes were taking place in the supervisory arena. The examination and supervisory functions at that time were separated, with the examination staff being employees of the FHLBB. The FHLBB was operating under severe budgetary and salary restraints and was unable to attract and retain an adequate staff of qualified examiners to cope with the growing list of fast-growth problem thrifts. Very quickly, the industry was changing from one that was relatively simple to one that was becoming fast-paced and increasingly complex. The supervision function was carried out by each of the twelve Federal Home Loan Banks. All in all, it was a cumbersome system that did not respond quickly to crisis resolution. The examination function was transferred to the district banks in mid-1985 but, by then, the situation was out of control.

When the examination function was transferred to the individual Federal Home Loan Banks, the budgetary and salary restraints were substantially alleviated. Subsequent to the transfer, it appears that substantial progress has been made in attracting quality examiners, some of whom have been recruited from the federal banking agencies. In addition, a substantial effort has been made to develop and implement high-quality training programs. However, because of the rapid growth in numbers of examination personnel, it will take several years to build a staff with heavy examination experience.

By the time the magnitude of the problems existing at the insolvent thrifts had been quantified, it was obvious that the FSLIC had neither the financial nor human resources to handle its caseload. Almost concurrently with passage of the necessary legislation to recapitalize the FSLIC, a new chairman and one new board member were taking office at the FHLBB. As expected, it took time for the newcomers at the FHLBB to familiarize themselves with the magnitude of the task at hand and to build their support team. Also, a tremendous amount of FHLBB resources were required to draft the numerous and comprehensive regulations required by the CEBA.

In summary, the cause of the current difficulties in the thrift industry cannot be traced to any one source. They have been caused by many factors.

OUTLOOK FOR THE VIABLE PORTION OF THE INDUSTRY

The outlook for the viable portion of the thrift industry is very difficult to quantify and, to a considerable extent, is closely linked to the disposition of the current insolvent thrifts. Continued publicity concerning the problems of the thrift industry and the FSLIC has been very injurious to solvent thrifts and has driven up the rates this group has to pay for savings deposits and other borrowings. Also, the cost of funds for all solvent thrifts is being driven up because they are forced to compete with the liquidity requirements of insolvent thrifts. In addition, the asset yields of solvent thrifts are being driven down by the necessity of competing with the insolvent thrifts for investment opportunities. Also, solvent thrifts find it necessary to pay a rate premium over the rates paid by commercial banks. It is believed that disposition of the large number of insolvent thrifts will tend to make this differential disappear or become smaller.

During the early part of this decade, we experienced hundreds of "interest-rate risk failures" and in recent years, we have experienced a tremendous number of "credit-risk failures." We may now be about to experience something which might come to be called "deregulation failures." Increased competition from many sectors of the economy has caused net interest spreads to narrow while at the same time, thrift operating cost ratios have soared. For the year ended December 31, 1987, net interest income for all GAAP solvent thrifts, expressed as a percentage of average assets, was 1.93% while total operating expenses was 1.94%. It is difficult to believe that other operating income, primarily derived from fees charged to thrift customers, will be adequate to cover net non-operating expenses, income taxes and still provide a reasonable return on equity. It appears that, in order to remain viable, the solvent thrifts will find it necessary to increase spreads and/or substantially reduce their operating expense ratios. Of course, other alternatives are to enter other lines of businesses or successfully develop and market new products.

In a world of electronic technology, high speed communications and the breakdown of legal and regulatory barriers to interstate banking, an efficient and effective financial system will require a far smaller number of financial institutions. In short, we are an "overbanked" nation with too many financial institutions and branches. A substantial consolidation of the current number of financial institutions, both thrifts and commercial banks, should help to improve the long term viability of the industry.

In addition, a period of prolonged higher interest rates would cause even the GAAP solvent thrifts to hemorrhage badly. To help insure its long term viability the industry has to continue restructuring its balance sheet to protect itself from undue interest rate risk.

Finally, the viability of the industry is largely dependent upon the strength of the U.S. economy, the level of interest rates and the strength of the real estate sector of the economy. However, because a substantial percentage of the assets of the industry is located in regional areas where the economy is considered depressed, the outlook is also partially dependent upon the economic recovery of those regional areas.

ABILITY OF THE REGULATORY SYSTEM TO DEAL WITH THE PROBLEMS

Because of the number of insolvencies which currently exist in the thrift industry and the budgetary and salary restraints under which the FHLBB has operated in the past, it is difficult to assess the ability of the regulators to deal with the problems that exist today. While almost no one will dispute the observation that massive problems remain unresolved today, few close observers of the FHLBB will dispute the fact that the agency simply has operated under budgetary restrictions that precluded it from building and staffing the organization with the resources necessary to deal with the challenges of deregulation and the rapid growth of the industry. Therefore, even if provided the resources today, the FHLBB still would have a huge backlog of cases to resolve and the job is too massive to complete overnight. A systematic and accelerated resolution of the current caseload of the FSLIC still will require financial and human resources substantially in excess of those currently available to the FHLBB and the FSLIC.

The Southwest plan has gotten off to a slow start. However, the FSLIC has beefed up its coordinating and negotiating teams within recent weeks. The substantial number of negotiations currently underway with potential thrift acquirers leads one to hope that a substantial number of the insolvent thrifts in Texas and other parts of the U.S. will be disposed of within the next few months.

CONCLUDING COMMENTS

It should be clear that deferring a comprehensive attack on the problems of the industry not only increases the ultimate cost of resolution, but also may call into question the safety and soundness of the entire financial system.

Unless a prototype plan for dealing with the massive number of insolvent thrifts is developed quickly, the FSLIC will drop further behind in dealing with problem institutions. It should be apparent from the forecasted financial statements included throughout this presentation that there are an additional number of thrifts likely to become insolvent within the foreseeable future.

There is no doubt in my mind that the resources available to the FSLIC will be inadequate to dispose of the insolvent thrifts. Also, there is still not a clear picture of what the cost will be to resolve the problems of institutions insured by the Federal Deposit Insurance Corporation ("FDIC"). There are indications that problem assets and problem institutions in the banking industry could easily match or exceed the present resources of the FDIC.

Consequently, the next President of the United States and Congress will again have to wrestle with the subject of deposit insurance for all types of financial institutions. In the meantime, it seems appropriate for Congress to reassure the world financial markets that the full faith and credit of the U. S. Government does stand behind the insurance funds. This would substantially reduce the cost of funds for many, if not the majority of financial institutions and restore to profitability many marginally profitable institutions, both in the banking and thrift industries.

Docket
Charter
District
Branches 22,010

ALL FSLIC INSURED THRIFTS

FINANCIAL HIGHLIGHTS
(Dollars in Thousands)

	1984	1985	1986	1987
Total Assets	$ 881,727,634	$ 991,751,753	$1,122,932,223	$1,250,112,886
% Change in Assets	22.14%	12.48%	13.23%	11.33%
Regulatory Capital	34,805,046	45,027,710	53,241,068	47,460,974
Estimated GAAP Capital	25,835,661	33,511,777	40,231,050	35,313,945
Tangible Capital	4,701,615	10,937,144	17,096,720	8,572,814
Regulatory Capital/Total Assets	3.95%	4.54%	4.74%	3.80%
Est. GAAP Capital/Total Assets	2.93%	3.38%	3.58%	2.82%
Tangible Capital/Total Assets	0.53%	1.10%	1.52%	0.69%
Net Income (Loss)	1,508,239	4,447,698	1,017,585	(6,306,736)
Return on Average Assets	0.19%	0.47%	0.10%	(0.53%)
Return on Avg. Regulatory Cap.	4.67%	11.14%	2.07%	(12.53%)
Yield on Loans	11.69%	11.47%	10.58%	9.54%
Yield on Investments	10.69%	9.39%	8.12%	7.90%
Yield on Earning Assets	11.55%	11.18%	10.24%	9.31%
Cost of Savings	9.95%	9.01%	7.84%	6.84%
Cost of Borrowings	10.78%	9.59%	8.74%	8.08%
Cost of Funds	10.07%	9.10%	8.00%	7.09%
Yield/Cost Spread	1.48%	2.08%	2.24%	2.22%
Amt.Elig. for Reg. Liquidity	94,096,442	100,043,512	115,221,510	100,670,551
Amt.Elig. for Reg.Liq./Tot.Assets	10.67%	10.09%	10.26%	8.05%
Int.Earn.Asst./Int.Bear.Liab.	94.48%	94.68%	94.96%	94.04%
Loans & Participations Purchased	52,233,776	54,355,724	64,747,291	63,513,741
Loans & Participations Sold	53,493,842	88,344,487	140,767,931	121,847,956
Mortg. Loans Serviced for Others	178,201,897	227,581,349	279,179,334	326,334,104
Mortg. Loans Serviced by Others	104,215,062	117,079,930	114,894,517	122,318,147
Broker Originated Deposits	37,067,447	38,514,437	42,589,493	63,838,436
Cash Div. on Preferred Stock	39,703	49,341	67,557	111,754
Cash Div. on Permanent Stock	383,913	366,583	546,723	990,605
Cash Div. on Other Cap. Inst.	942	5,103	17,625	95,257
Non 1-4 Con./Conv.Lns./Tot.Asst	16.85%	19.08%	18.61%	17.68%
Balloon & Adj. Rate Loans	204,613,141	281,065,224	336,115,492	421,413,214
Ser.Corp.Inc./Inv.in Ser.Corp.	10.00%	9.51%	5.02%	1.05%
OTHER INFORMATION				
Annual Closing Date	N/A	N/A	N/A	N/A
No. of Wholly-Owned Ser. Corps.	3,279	3,701	4,119	4,433
No. of Deposit Accounts	102,061,981	103,376,463	106,379,561	110,440,247

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ALL FSLIC INSURED THRIFTS
BALANCE SHEETS
(Dollars in Thousands)

ASSETS	1984	1985	1986	1987
Construction Loans On:				
1-4 Dwelling Units	$ N/A	$ N/A	$ N/A	$ 21,324,031
5 or More Dwelling Units	N/A	N/A	N/A	12,338,223
Nonresidential	N/A	N/A	N/A	19,009,679
Permanent Mortgages On:				
1-4 Dwelling Units	396,626,964	419,146,453	430,151,491	469,937,828
5 or More Dwelling Units	57,462,940	70,420,271	79,381,058	73,173,924
Nonresidential (Except Land)	72,730,701	91,634,846	99,697,353	88,893,469
Dev. Bldg. Lots, Land, Etc.	18,360,610	27,159,910	29,873,695	27,652,402
Mortgage Backed Securities	103,349,840	110,547,876	155,258,663	198,563,442
Accrued Interest Receivable	6,586,163	7,871,690	8,839,760	9,870,086
Other Mortgage Receivables	22,094,155	20,958,899	23,740,706	3,052,407
Loans in Process	(23,032,481)	(25,672,092)	(24,570,085)	(23,467,560)
Unearned Disc. & Def. Loan Fees	(13,447,520)	(11,170,818)	(8,663,410)	(8,919,057)
Specific Reserves & Val. Allow.	(2,147,355)	(3,162,080)	(6,014,510)	(9,732,804)
Net Mortgage Loans	638,584,035	707,734,955	787,694,700	881,696,067
Commercial Loans	9,838,202	14,582,653	21,635,187	22,651,015
Consumer Loans	30,712,532	41,325,245	48,362,911	56,335,230
Financing Leases	360,250	703,790	840,251	1,253,881
Accrued Interest Receivable	548,162	735,905	890,663	968,961
Loans in Process	(542,955)	(672,203)	(663,614)	(789,862)
Unearned Disc. & Def. Loan Fees	(705,859)	(929,798)	(981,731)	(839,508)
Specific Reserves & Val. Allow.	(228,440)	(555,607)	(1,100,593)	(1,843,687)
Net Nonmortgage Loans	39,981,904	55,190,034	68,983,061	77,736,043
Repossessed Assets	4,547,146	8,152,294	14,856,027	25,084,324
Valuation Allowances	(570,741)	(1,126,384)	(2,636,339)	(5,295,006)
Net Repossessed Assets	3,976,405	7,025,910	12,219,688	19,789,318
Real Estate Held For Dev., Etc.	4,651,955	6,155,345	7,679,356	8,409,778
Valuation Allowances	(82,970)	(297,884)	(555,806)	(982,473)
Net Real Estate Held for Dev.	4,568,985	5,857,461	7,123,550	7,427,305
Cash & Demand Deposits	11,053,630	13,049,691	17,235,809	16,321,660
U.S. Govt. & Agency Securities	41,460,611	38,077,178	43,622,037	50,553,365
Equity Sec., Except FHLB/FHLMC	N/A	1,188,732	1,171,971	1,238,779
Other Investments	69,507,357	79,779,061	95,041,288	98,608,548
Accrued Interest Receivable	1,754,911	1,589,435	1,580,637	1,899,693
Valuation Allowances	(36,116)	(61,344)	(149,130)	(343,042)
Net Cash & Investment Sec.	123,740,393	133,622,753	158,502,612	168,279,003
Net Fixed Assets	11,155,428	12,570,212	14,245,287	15,632,966
Investment in Ser. Corps./Subs.	14,026,226	19,317,367	20,249,743	22,584,375
Deferred Net Losses (Gains)	5,906,934	6,158,321	5,685,807	4,906,359
Intangible Assets	21,134,046	22,574,633	23,134,330	26,741,131
Other Assets	18,653,282	21,700,045	25,093,287	25,320,298
TOTAL ASSETS	$ 881,727,634	$ 991,751,753	$1,122,932,223	$1,250,112,886

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ALL FSLIC INSURED THRIFTS
BALANCE SHEETS
(Dollars in Thousands)

LIABILITIES	1984	1985	1986	1987
Fixed-Maturity Deposits	$ 523,772,631	$ 564,472,787	$ 594,352,890	$ 669,193,179
Transaction Accounts	25,955,172	33,917,683	50,216,293	56,685,987
Money Market Deposit Accounts	98,474,549	120,413,657	133,893,330	118,133,163
Passbook Accounts	57,744,534	59,317,801	76,646,290	87,223,408
Total Savings Deposits	705,946,886	778,121,928	855,108,803	931,235,737
FHLB Advances	64,638,275	77,712,000	96,151,431	116,287,968
Repurchase Agreements	43,987,190	44,631,775	58,941,502	85,463,150
Commercial Paper Issued	296,576	695,849	776,028	2,129,725
Sub.Deb. not Qual. as Reg.Cap.	614,867	624,698	235,298	198,461
Mortgage-Backed Bonds Issued	4,644,885	8,270,417	12,213,529	15,894,406
Other Borrowings	10,421,630	16,194,663	23,064,056	29,603,095
Other Liabilities	16,370,923	20,472,538	23,200,440	21,839,230
TOTAL LIABILITIES	846,922,592	946,724,038	1,069,691,146	1,202,651,906
REGULATORY CAPITAL				
Preferred Stock	294,727	302,806	345,968	1,016,449
Permanent Stock	833,499	1,089,617	1,370,732	1,696,150
Contributed Capital	6,937,043	10,732,505	17,431,832	20,125,892
Qualifying Mutual Cap. Cert.	5,516	3,106	5,533	5,943
Qualifying Subordinated Deb.	1,001,541	1,966,248	3,357,551	3,754,331
Appraised Equity Capital	1,308,528	1,585,320	2,137,590	1,981,319
Net Worth & Income Cap. Cert.	924,604	2,120,946	2,104,771	1,749,030
Retained Earnings (Deficit)	23,499,591	27,227,129	26,487,096	17,131,872
TOTAL REGULATORY CAPITAL	34,805,046	45,027,710	53,241,068	47,460,974
TOTAL LIAB. & REG. CAPITAL	$ 881,727,637	$ 991,751,753	$1,122,932,213	$1,250,112,883

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ALL FSLIC INSURED THRIFTS
STATEMENTS OF OPERATIONS
(Dollars in Thousands)

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	1984	1985	1986	1987
Interest Income	$ 82,790,233	$ 92,875,388	$ 95,946,927	$ 98,120,295
Interest Expense	75,586,253	79,703,437	78,982,181	78,981,614
Net Interest Inc. (Exp.)	7,203,980	13,171,951	16,964,746	19,138,681
Other Operating Income:				
Mortgage Loan Fees	3,175,072	3,272,073	3,694,692	3,279,601
Loan Servicing Fees	430,615	649,445	871,252	1,059,163
Other Loan Fees & Charges	700,261	860,311	1,082,474	1,037,718
Ser.Chgs. & Fees - Trans.Accts.	385,601	572,906	729,969	873,922
Service Corps./Subsidiaries	1,021,283	1,586,202	992,518	224,954
Other	1,969,456	1,879,207	2,350,095	1,527,266
Total Oth. Operating Income	7,682,288	8,820,144	9,721,000	8,002,624
Operating Expense:				
Officers & Employees Comp.	5,674,540	6,833,492	8,217,001	9,351,373
Legal Expense	159,720	221,685	344,232	450,259
Office Occ. & Equip. Expense	2,811,112	3,335,578	3,968,535	4,488,604
Marketing Expense	718,912	760,713	827,914	932,921
Professional Services	318,377	430,236	535,584	627,309
Amortization of Goodwill	719,271	922,641	1,113,715	1,209,690
Other	3,232,895	5,229,760	6,278,045	6,770,338
Total Operating Expense	13,634,827	17,734,105	21,285,026	23,830,494
NET OPER. INCOME (DEFICIT)	1,251,441	4,257,990	5,400,720	3,310,811
Non-Operating Income:				
Profit on Sale of REO & Other	503,081	535,494	516,008	577,730
Profit on Sale of Investments	623,593	1,870,290	2,565,170	1,313,469
Profit on Sale of Loans	1,211,567	3,150,483	4,316,789	2,614,930
Amortized Deferred Gains	56,405	78,029	55,144	46,312
Other	1,054,596	866,739	892,905	1,232,412
Total Non-Operating Income	3,449,242	6,501,035	8,346,016	5,784,853
Non-Operating Expense:				
Provision for Losses on Assets	N/A	N/A	N/A	8,164,258
Loss on Sale of REO & Other	579,379	822,899	1,773,900	688,061
Loss on Sale of Investments	235,038	404,202	603,634	677,909
Loss on Sale of Loans	1,047,887	1,602,373	4,409,565	860,356
Amortized Deferred Losses	193,124	305,284	365,448	384,274
Other	342,066	527,390	1,255,954	1,706,204
Total Non-Operating Expense	2,397,494	3,662,148	8,408,501	12,481,062
INCOME (LOSS) BEF. TAXES & ADJ.	2,303,189	7,096,877	5,338,235	(3,385,398)
Income Taxes (Credits)	711,421	2,047,814	3,112,099	2,688,221
NET INCOME (LOSS) BEFORE ADJ.	1,590,306	5,047,991	2,225,897	(6,073,809)
Prior Period Adjustments	(82,060)	(600,312)	(1,208,310)	(232,923)
ADJUSTED NET INCOME (LOSS)	$ 1,508,239	$ 4,447,698	$ 1,017,585	$ (6,306,736)

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ALL FSLIC INSURED THRIFTS
FINANCIAL RATIOS - BALANCE SHEETS
(As a Percent of Total Assets)

ASSETS	1984	1985	1986	1987
Construction Loans On:				
1-4 Dwelling Units	N/A	N/A	N/A	1.71
5 or More Dwelling Units	N/A	N/A	N/A	0.99
Nonresidential	N/A	N/A	N/A	1.52
Permanent Mortgages On:				
1-4 Dwelling Units	44.98	42.26	38.31	37.59
5 or More Dwelling Units	6.52	7.10	7.07	5.85
Nonresidential (Except Land)	8.25	9.24	8.88	7.11
Dev. Bldg. Lots, Land, Etc.	2.08	2.74	2.66	2.21
Mortgage Backed Securities	11.72	11.15	13.83	15.88
Accrued Interest Receivable	0.75	0.79	0.79	0.79
Other Mortgage Receivables	2.51	2.11	2.11	0.24
Loans in Process	(2.61)	(2.59)	(2.19)	(1.88)
Unearned Disc. & Def. Loan Fees	(1.53)	(1.13)	(0.77)	(0.71)
Specific Reserves & Val. Allow.	(0.24)	(0.32)	(0.54)	(0.78)
Net Mortgage Loans	72.42	71.36	70.15	70.53
Commercial Loans	1.12	1.47	1.93	1.81
Consumer Loans	3.48	4.17	4.31	4.51
Financing Leases	0.04	0.07	0.07	0.10
Accrued Interest Receivable	0.06	0.07	0.08	0.08
Loans in Process	(0.06)	(0.07)	(0.06)	(0.06)
Unearned Disc. & Def. Loan Fees	(0.08)	(0.09)	(0.09)	(0.07)
Specific Reserves & Val. Allow.	(0.03)	(0.06)	(0.10)	(0.15)
Net Nonmortgage Loans	4.53	5.56	6.14	6.22
Repossessed Assets	0.52	0.82	1.32	2.01
Valuation Allowances	(0.06)	(0.11)	(0.23)	(0.42)
Net Repossessed Assets	0.45	0.71	1.09	1.58
Real Estate Held For Dev., Etc.	0.53	0.62	0.68	0.67
Valuation Allowances	(0.01)	(0.03)	(0.05)	(0.08)
Net Real Estate Held for Dev.	0.52	0.59	0.63	0.59
Cash & Demand Deposits	1.25	1.32	1.53	1.31
U.S. Govt. & Agency Securities	4.70	3.84	3.88	4.04
Equity Sec., Except FHLB/FHLMC	N/A	0.12	0.10	0.10
Other Investments	7.88	8.04	8.46	7.89
Accrued Interest Receivable	0.20	0.16	0.14	0.15
Valuation Allowances	0.00	(0.01)	(0.01)	(0.03)
Net Cash & Investment Sec.	14.03	13.47	14.12	13.46
Net Fixed Assets	1.27	1.27	1.27	1.25
Investment in Ser. Corps./Subs.	1.59	1.95	1.80	1.81
Deferred Net Losses (Gains)	0.67	0.62	0.51	0.39
Intangible Assets	2.40	2.28	2.06	2.14
Other	2.12	2.19	2.23	2.03
TOTAL ASSETS	100.00	100.00	100.00	100.00

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ALL FSLIC INSURED THRIFTS
FINANCIAL RATIOS - BALANCE SHEETS
(As a Percent of Total Assets)

LIABILITIES	1984	1985	1986	1987
Fixed-Maturity Deposits	59.40	56.92	52.93	53.53
Transaction Accounts	2.94	3.42	4.47	4.53
Money Market Deposit Accounts	11.17	12.14	11.92	9.45
Passbook Accounts	6.55	5.98	6.83	6.98
Total Savings Deposits	80.06	78.46	76.15	74.49
FHLB Advances	7.33	7.84	8.56	9.30
Repurchase Agreements	4.99	4.50	5.25	6.84
Commercial Paper Issued	0.03	0.07	0.07	0.17
Sub. Deb. not Qual. as Reg. Cap.	0.07	0.06	0.02	0.02
Mortgage-Backed Bonds Issued	0.53	0.83	1.09	1.27
Other Borrowings	1.18	1.63	2.05	2.37
Other Liabilities	1.86	2.06	2.07	1.75
TOTAL LIABILITIES	96.05	95.46	95.26	96.20
REGULATORY CAPITAL				
Preferred Stock	0.03	0.03	0.03	0.08
Permanent Stock	0.09	0.11	0.12	0.14
Contributed Capital	0.79	1.08	1.55	1.61
Qualifying Mutual Cap. Cert.	0.00	0.00	0.00	0.00
Qualifying Subordinated Deb.	0.11	0.20	0.30	0.30
Appraised Equity Capital	0.15	0.16	0.19	0.16
Net Worth & Income Cap. Cert.	0.10	0.21	0.19	0.14
Retained Earnings (Deficit)	2.67	2.75	2.36	1.37
TOTAL REGULATORY CAPITAL	3.95	4.54	4.74	3.80
TOTAL LIABILITIES & REG. CAP.	100.00	100.00	100.00	100.00

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ALL FSLIC INSURED THRIFTS
FINANCIAL RATIOS - STATEMENTS OF OPERATIONS
(As a Percent of Average Assets)

	1984	1985	1986	1987
Interest Income	10.33	9.91	9.07	8.27
Interest Expense	9.43	8.51	7.47	6.66
Net Interest Inc. (Exp.)	0.90	1.41	1.60	1.61
Other Operating Income:				
Mortgage Loan Fees	0.40	0.35	0.35	0.28
Loan Servicing Fees	0.05	0.07	0.08	0.09
Other Loan Fees & Charges	0.09	0.09	0.10	0.09
Ser.Chgs. & Fees-Trans.Accts	0.05	0.06	0.07	0.07
Service Corps./Subsidiaries	0.13	0.17	0.09	0.02
Other	0.25	0.20	0.22	0.13
Total Oth. Operating Income	0.96	0.94	0.92	0.67
Operating Expense:				
Officers & Employees Comp.	0.71	0.73	0.78	0.79
Legal Expense	0.02	0.02	0.03	0.04
Office Occ. & Equip. Expense	0.35	0.36	0.38	0.38
Marketing Expense	0.09	0.08	0.08	0.08
Professional Services	0.04	0.05	0.05	0.05
Amortization of Goodwill	0.09	0.10	0.11	0.10
Other	0.40	0.56	0.59	0.57
Total Operating Expense	1.70	1.89	2.01	2.01
NET OPER. INCOME (DEFICIT)	0.16	0.45	0.51	0.28
Non-Operating Income:				
Profit on Sale of REO & Other	0.06	0.06	0.05	0.05
Profit on Sale of Investments	0.08	0.20	0.24	0.11
Profit on Sale of Loans	0.15	0.34	0.41	0.22
Amortized Deferred Gains	0.01	0.01	0.01	0.00
Other	0.13	0.09	0.08	0.10
Total Non-Operating Income	0.43	0.69	0.79	0.49
Non-Operating Expense:				
Provision for Losses on Assets	N/A	N/A	N/A	0.69
Loss on Sale of REO & Other	0.07	0.09	0.17	0.06
Loss on Sale of Investments	0.03	0.04	0.06	0.06
Loss on Sale of Loans	0.13	0.17	0.42	0.07
Amortized Deferred Losses	0.02	0.03	0.03	0.03
Other	0.04	0.06	0.12	0.14
Total Non-Operating Expense	0.30	0.39	0.80	1.05
INCOME (LOSS) BEF. TAXES & ADJ.	0.29	0.76	0.50	(0.29)
Income Taxes (Credits)	0.09	0.22	0.29	0.23
NET INCOME (LOSS) BEFORE ADJ.	0.20	0.54	0.21	(0.51)
Prior Period Adjustments	(0.01)	(0.06)	(0.11)	(0.02)
ADJUSTED NET INCOME (LOSS)	0.19	0.47	0.10	(0.53)

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ALL FSLIC INSURED THRIFTS
QUARTERLY STATEMENTS OF OPERATIONS
(Dollars in Thousands)

	3/31/87	6/30/87	9/30/87	12/31/87
Interest Income	$ 23,510,137	$ 24,052,104	$ 24,723,649	$ 25,834,405
Interest Expense	18,586,897	18,954,125	20,028,952	21,411,640
Net Interest Inc. (Exp.)	4,923,240	5,097,979	4,694,697	4,422,765
Other Operating Income:				
Mortgage Loan Fees	706,817	972,467	830,511	769,806
Loan Servicing Fees	232,624	269,685	270,335	286,519
Other Loan Fees & Charges	248,729	280,644	260,384	247,961
Ser.Chgs. & Fees-Trans.Accts	200,084	210,267	224,060	239,511
Service Corps./Subsidiaries	168,131	256,182	45,665	(245,024)
Other	484,178	334,480	343,095	365,513
Total Oth. Operating Income	2,040,563	2,323,725	1,974,050	1,664,286
Operating Expense:				
Officers & Employees Comp.	2,254,039	2,307,435	2,342,918	2,446,981
Legal Expense	87,930	107,308	119,801	135,220
Office Occ. & Equip. Expense	1,068,220	1,095,098	1,137,830	1,187,456
Marketing Expense	210,052	242,833	226,629	253,407
Professional Services	142,272	156,630	156,259	172,148
Amortization of Goodwill	274,525	292,929	296,469	345,767
Other	1,598,881	1,739,074	1,633,290	1,799,093
Total Operating Expense	5,635,919	5,941,307	5,913,196	6,340,072
NET OPER. INCOME (DEFICIT)	1,327,884	1,480,397	755,551	(253,021)
Non-Operating Income:				
Profit on Sale of REO & Other	109,762	153,277	129,175	185,516
Profit on Sale of Investments	441,611	347,361	229,809	294,688
Profit on Sale of Loans	1,210,889	635,498	434,993	333,550
Amortized Deferred Gains	8,238	10,220	19,674	8,180
Other	161,075	364,765	279,199	427,373
Total Non-Operating Income	1,931,575	1,511,121	1,092,850	1,249,307
Non-Operating Expense:				
Provision for Losses on Assets	1,242,783	2,306,935	1,870,449	2,744,091
Loss on Sale of REO & Other	146,677	192,318	151,159	197,907
Loss on Sale of Investments	104,519	224,956	154,805	193,629
Loss on Sale of Loans	164,473	224,830	217,650	253,403
Amortized Deferred Losses	86,722	80,628	126,363	90,561
Other	260,570	937,141	251,384	257,109
Total Non-Operating Expense	2,005,744	3,966,808	2,771,810	3,736,700
INCOME (LOSS) BEF. TAXES & ADJ.	1,253,715	(975,290)	(923,409)	(2,740,414)
Income Taxes (Credits)	993,768	705,998	580,737	407,718
NET INCOME (LOSS) BEFORE ADJ.	259,859	(1,681,333)	(1,504,258)	(3,148,077)
Prior Period Adjustments	(43,416)	(84,853)	(11,940)	(92,714)
ADJUSTED NET INCOME (LOSS)	$ 216,443	$ (1,766,187)	$ (1,516,199)	$ (3,240,793)

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ALL FSLIC INSURED THRIFTS
SELECTED FINANCIAL INFORMATION AT DECEMBER 31, 1987
(Dollars in Thousands)

Institution Name	Total Assets	Regulatory Capital	Reg. Cap./ Assets	Estimated GAAP Cap.	Est. GAAP Capital/ Assets	Tangible Capital	Tangible Capital/ Assets	Int.Earn. Asst/Int. Bear.Liab	Non 1-4 Con/Conv Lns/Assts	Net Repos Assets/ Tot Asst	Serv.Corp Inv./ Tot Asst	Net Oper. Income (Deficit)	Net Op. Inc (Def)/ Avg Asst	Adjusted Net Income (Loss)	Adj. Net Inc(Loss)/ Avg Asst
CT Totals, 28 Institutions	12,727,485	812,692	6.39	759,152	5.96	525,477	4.13	101.65	5.61	0.16	0.33	55,618	0.48	34,708	0.30
ME Totals, 15 Institutions	1,468,697	109,218	7.44	106,845	7.27	66,364	4.52	100.63	4.99	0.11	0.07	13,817	1.03	11,557	0.86
MA Totals, 34 Institutions	9,393,246	628,935	6.70	572,423	6.09	383,628	4.08	96.12	11.95	0.05	1.38	89,850	1.09	73,941	0.90
NH Totals, 12 Institutions	2,043,232	180,255	8.82	177,129	8.67	162,987	7.98	105.12	10.51	0.08	0.63	21,006	1.09	12,943	0.67
RI Totals, 4 Institutions	4,074,779	263,750	6.47	257,951	6.33	170,663	4.19	93.17	37.23	1.24	6.19	35,787	0.93	341	0.01
VT Totals, 4 Institutions	516,303	31,177	6.04	29,266	5.67	26,351	5.10	98.40	6.59	0.12	0.47	4,954	1.05	3,904	0.83
NJ Totals, 136 Institutions	53,145,488	2,569,252	4.83	2,098,132	3.95	1,002,247	1.89	97.08	11.76	0.43	0.84	468,333	0.91	161,825	0.31
NY Totals, 86 Institutions	55,778,463	3,027,220	5.43	2,384,158	4.27	(160,476)	(0.29)	95.79	12.52	0.27	0.94	456,034	0.88	308,974	0.59
PR Totals, 10 Institutions	6,233,146	436,155	7.00	325,500	5.22	289,374	4.64	102.75	8.91	0.17	0.62	73,624	1.25	49,498	0.84
DE Totals, 4 Institutions	435,235	12,328	2.83	10,805	2.48	(2,715)	(0.62)	95.61	6.26	0.03	0.43	975	0.25	(234)	(0.06)
PA Totals, 169 Institutions	42,740,628	2,380,076	5.57	2,084,390	4.88	907,375	2.12	97.70	10.49	0.38	1.02	421,033	1.04	208,563	0.52
WV Totals, 18 Institutions	2,010,657	87,137	4.33	78,920	3.93	37,292	1.85	94.31	13.92	1.89	1.02	3,591	0.17	(16,277)	(0.79)
AL Totals, 35 Institutions	8,961,252	372,072	4.15	281,996	3.15	140,786	1.57	96.66	14.05	1.19	1.00	35,301	0.41	(12,235)	(0.14)
DC Totals, 6 Institutions	4,426,407	272,535	6.16	212,669	4.80	84,048	1.90	100.23	10.68	0.11	0.82	2,786	0.06	1,378	0.03
FL Totals, 148 Institutions	80,147,935	3,334,023	4.16	2,915,709	3.64	1,351,139	1.69	95.15	13.99	0.94	2.21	225,872	0.30	(67,228)	(0.09)
GA Totals, 69 Institutions	18,218,893	911,121	5.00	791,682	4.35	491,670	2.70	97.78	13.92	0.66	0.94	147,434	0.86	69,052	0.40
MD Totals, 96 Institutions	20,962,293	1,033,986	4.93	671,481	3.20	395,890	1.89	97.74	18.97	0.39	0.76	148,306	0.76	2,344	0.01
NC Totals, 136 Institutions	20,056,128	1,274,872	6.36	1,102,357	5.50	894,570	4.46	100.03	14.35	0.45	0.68	274,416	1.40	135,444	0.69
SC Totals, 49 Institutions	10,877,128	560,479	5.15	450,815	4.14	325,657	2.99	97.52	15.49	0.54	0.76	104,483	0.98	48,897	0.46
VA Totals, 66 Institutions	25,633,904	1,458,221	5.69	1,089,440	4.25	641,121	2.50	96.33	19.85	1.00	1.74	96,817	0.40	54,982	0.23
KY Totals, 67 Institutions	7,493,936	424,538	5.67	379,482	5.06	345,617	4.61	100.50	8.79	0.48	0.89	64,924	0.88	1,288	0.02
OH Totals, 224 Institutions	52,835,288	2,735,098	5.18	2,225,823	4.21	1,211,069	2.29	97.61	15.58	0.53	1.26	465,923	0.90	131,241	0.25
TN Totals, 63 Institutions	11,261,493	818,002	7.26	683,586	6.07	514,627	4.57	99.86	12.87	0.52	1.00	131,147	1.20	50,829	0.47
IN Totals, 112 Institutions	13,657,959	799,584	5.85	698,768	5.12	522,986	3.83	99.63	8.37	0.70	0.24	117,260	0.89	29,455	0.22

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ALL FSLIC INSURED THRIFTS
SELECTED FINANCIAL INFORMATION AT DECEMBER 3' 1987
(Dollars in Thousands)

Institution Name	Total Assets	Regulatory Capital	Reg. Cap./ Assets	Estimated GAAP Cap.	Est. GAAP Capital/ Assets	Tangible Capital	Tangible Capital/ Assets	Int.Earn. Asst/Int. Bear.Liab	Non 1-4 Con/Conv Lns/Assts	Net Repo. Assets/ Tot Asst	Serv.Corp Inv./ Tot Asst	Net Oper. Income (Deficit)	Net Op. Inc (Def)/ Avg Asst	Adjusted Net Income (Loss)	Adj. Net Inc(Loss)/ Avg Asst
MI Totals, 51 Institutions	37,197,979	1,808,710	4.86	1,420,289	3.82	891,877	2.40	99.89	6.26	0.25	0.29	195,399	0.55	148,247	0.41
IL Totals, 263 Institutions	68,857,264	4,424,642	6.43	3,543,267	5.15	1,554,351	2.26	98.57	10.78	0.74	0.89	536,800	0.82	206,333	0.31
WI Totals, 75 Institutions	16,402,030	1,099,137	6.70	1,074,684	6.55	1,012,859	6.18	101.80	13.64	0.81	0.87	158,615	1.01	66,248	0.42
IA Totals, 50 Institutions	8,715,308	153,022	1.76	51,807	0.59	(69,723)	(0.80)	93.58	17.24	2.22	0.75	19,871	0.23	(78,197)	(0.89)
MN Totals, 36 Institutions	16,314,441	459,564	2.82	114,758	0.70	(289,953)	(1.78)	89.41	14.94	0.86	2.90	(48,392)	(0.30)	(74,381)	(0.46)
MO Totals, 81 Institutions	23,993,796	1,042,559	4.35	726,934	3.03	359,648	1.50	97.54	13.45	1.24	0.93	105,412	0.46	22,395	0.10
ND Totals, 6 Institutions	4,231,777	207,003	4.89	136,360	3.22	(3,173)	(0.07)	95.41	11.67	0.87	1.23	16,573	0.41	14,423	0.35
SD Totals, 12 Institutions	1,409,407	60,751	4.31	45,826	3.25	21,746	1.54	97.32	19.54	1.16	0.15	19,177	1.37	2,277	0.16
AR Totals, 37 Institutions	6,796,208	(271,562)	(4.00)	(371,280)	(5.46)	(544,885)	(8.02)	85.67	29.56	5.10	1.52	(75,764)	(1.12)	(200,533)	(2.97)
LA Totals, 96 Institutions	15,694,496	912,938	5.82	692,440	4.41	163,096	1.04	91.49	21.89	3.14	3.12	(69,483)	(0.47)	(310,803)	(2.11)
MS Totals, 42 Institutions	5,110,139	260,211	5.09	158,054	3.09	52,867	1.03	91.32	15.22	1.76	3.17	15,406	0.31	(3,109)	(0.06)
NM Totals, 25 Institutions	6,033,242	43,213	0.72	(18,560)	(0.31)	(147,564)	(2.45)	85.04	20.69	5.70	2.66	(34,636)	(0.58)	(171,024)	(2.87)
TX Totals, 278 Institutions	98,795,586	(6,206,199)	(6.28)	(7,373,309)	(7.46)	(10,788,052)	(10.92)	71.64	29.62	9.56	4.95	(3,109,034)	(3.23)	(6,666,186)	(6.93)
CO Totals, 36 Institutions	14,750,233	558,614	3.79	470,795	3.19	425,346	2.88	96.37	28.29	2.22	1.42	(33,248)	(0.24)	(112,392)	(0.79)
KS Totals, 55 Institutions	20,493,366	925,188	4.51	778,617	3.80	701,054	3.42	97.07	12.56	1.22	1.85	169,227	0.93	47,400	0.26
NE Totals, 23 Institutions	11,366,007	262,945	2.31	187,990	1.65	(69,486)	(0.61)	92.81	14.20	1.68	1.71	22,294	0.22	(45,547)	(0.45)
OK Totals, 53 Institutions	10,130,254	(201,204)	(1.99)	(308,210)	(3.04)	(536,211)	(5.29)	86.68	18.27	5.18	1.31	(118,323)	(1.23)	(453,757)	(4.72)
AZ Totals, 12 Institutions	24,096,726	952,988	3.95	694,466	2.88	(23,973)	(0.10)	89.21	30.20	1.63	2.65	(1,814)	(0.01)	(62,040)	(0.27)
CA Totals, 206 Institutions	346,360,586	14,341,076	4.14	11,124,521	3.21	5,324,782	1.54	95.83	22.10	0.76	2.11	1,859,283	0.57	148,239	0.05
NV Totals, 5 Institutions	4,622,969	269,508	5.83	262,929	5.69	123,274	2.67	97.69	15.73	1.10	0.28	57,268	1.32	30,139	0.69
AK Totals, 3 Institutions	529,270	(9,853)	(1.86)	(13,167)	(2.49)	(13,667)	(2.58)	92.57	37.23	4.43	1.32	(9,195)	(1.72)	(39,826)	(7.44)
HI Totals, 6 Institutions	5,511,169	296,760	5.38	251,200	4.56	148,309	2.69	98.91	9.04	0.97	0.82	62,339	1.36	56,019	1.22
ID Totals, 7 Institutions	929,206	67,197	7.23	41,589	4.48	41,589	4.48	98.91	11.13	0.88	0.50	8,275	0.88	(511)	(0.05)
MT Totals, 11 Institutions	1,220,039	89,702	7.35	77,501	6.35	77,501	6.35	101.23	12.52	1.28	0.17	13,586	1.12	2,491	0.21

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ALL FSLIC INSURED THRIFTS
SELECTED FINANCIAL INFORMATION AT DECEMBER 31, 1987

(Dollars in Thousands)

Institution Name	Total Assets	Regulatory Capital	Reg. Cap./ Assets	Estimated GAAP Cap.	Est. GAAP Capital/ Assets	Tangible Capital	Tangible Capital/ Assets	Int.Earn. Asst/Int. Bear.Liab	Non 1-4 Con/Conv Lns/Assts	Net Repos Assets/ Tot Asst	Serv.Corp Inv./ Tot Asst	Net Oper. Income (Deficit)	Net Op. Inc (Def)/ Avg Asst	Adjusted Net Income (Loss)	Adj. Net Inc(Loss)/ Avg Asst
OR Totals, 16 Institutions	9,523,667	131,935	1.39	46,116	0.48	(574,995)	(6.04)	86.60	13.26	1.79	1.52	(32,276)	(0.35)	(92,651)	(1.00)
UT Totals, 13 Institutions	7,087,011	188,098	2.65	170,134	2.40	(211,476)	(2.98)	87.55	17.87	1.47	2.61	(30,242)	(0.48)	(83,926)	(1.34)
WA Totals, 39 Institutions	17,537,686	1,069,372	6.10	963,621	5.49	649,505	3.70	97.77	18.03	1.40	0.70	161,825	0.98	90,227	0.55
WY Totals, 11 Institutions	1,208,219	(23,671)	(1.96)	(37,384)	(3.09)	(37,466)	(3.10)	86.30	12.73	4.10	1.97	(9,621)	(0.77)	(42,474)	(3.39)
GU Totals, 2 Institutions	94,830	15,604	16.45	13,478	14.21	7,887	8.32	103.42	13.30	0	0.42	2,198	2.42	993	1.10
Grand Totals, 3141 Institutions	1,250,112,886	47,460,974	3.80	35,313,945	2.82	8,572,814	0.69	94.04	17.68	1.58	1.81	3,310,811	0.28	(6,306,736)	(0.51)

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ALL FSLIC INSURED THRIFTS
FINANCIAL RATIOS - QUARTERLY STATEMENTS OF OPERATIONS
(As a Percent of Average Assets)

	3/31/87	6/30/87	9/30/87	12/31/87
Interest Income	7.93	8.11	8.33	8.71
Interest Expense	6.27	6.39	6.75	7.22
Net Interest Inc. (Exp.)	1.66	1.72	1.58	1.49
Other Operating Income:				
Mortgage Loan Fees	0.24	0.33	0.28	0.26
Loan Servicing Fees	0.08	0.09	0.09	0.10
Other Loan Fees & Charges	0.08	0.09	0.09	0.08
Ser.Chgs. & Fees-Trans.Accts	0.07	0.07	0.08	0.08
Service Corps./Subsidiaries	0.06	0.09	0.02	(0.08)
Other	0.16	0.11	0.12	0.12
Total Other Oper. Income	0.69	0.78	0.67	0.56
Operating Expense:				
Officers & Employees Comp.	0.76	0.78	0.79	0.82
Legal Expense	0.03	0.04	0.04	0.05
Office Occ. & Equip. Expense	0.36	0.37	0.38	0.40
Marketing Expense	0.07	0.08	0.08	0.09
Professional Services	0.05	0.05	0.05	0.06
Amortization of Goodwill	0.09	0.10	0.10	0.12
Other	0.54	0.59	0.55	0.61
Total Operating Expense	1.90	2.00	1.99	2.14
NET OPER. INCOME (DEFICIT)	0.45	0.50	0.25	(0.09)
Non-Operating Income:				
Profit on Sale of REO & Other	0.04	0.05	0.04	0.06
Profit on Sale of Investments	0.15	0.12	0.08	0.10
Profit on Sale of Loans	0.41	0.21	0.15	0.11
Amortized Deferred Gains	0.00	0.00	0.01	0.00
Other	0.05	0.12	0.09	0.14
Total Non-Operating Income	0.65	0.51	0.37	0.42
Non-Operating Expense:				
Provision for Losses on Assets	0.42	0.78	0.63	0.93
Loss on Sale of REO & Other	0.05	0.06	0.05	0.07
Loss on Sale of Investments	0.04	0.08	0.05	0.07
Loss on Sale of Loans	0.06	0.08	0.07	0.09
Amortized Deferred Losses	0.03	0.03	0.04	0.03
Other	0.09	0.32	0.08	0.09
Total Non-Operating Expense	0.68	1.34	0.93	1.26
INCOME (LOSS) BEF. TAXES & ADJ.	0.42	(0.33)	(0.31)	(0.92)
Income Taxes (Credits)	0.34	0.24	0.20	0.14
NET INCOME (LOSS) BEFORE ADJ.	0.09	(0.57)	(0.51)	(1.06)
Prior Period Adjustments	(0.01)	(0.03)	(0.00)	(0.03)
ADJUSTED NET INCOME (LOSS)	0.07	(0.60)	(0.51)	(1.09)

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Docket
Charter
District
Branches 18,465

GAAP SOLVENT FSLIC THRIFTS

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FINANCIAL HIGHLIGHTS
(Dollars in Thousands)

	1984	1985	1986	1987
Total Assets	$ 768,685,308	$ 859,937,317	$ 981,446,164	$1,107,198,334
% Change in Assets	22.13%	11.87%	14.13%	12.81%
Regulatory Capital	31,584,044	41,813,315	55,927,520	62,297,114
Estimated GAAP Capital	25,871,211	34,488,088	47,408,583	54,413,363
Tangible Capital	7,288,088	14,819,140	27,341,130	30,962,782
Regulatory Capital/Total Assets	4.11%	4.86%	5.70%	5.63%
Est. GAAP Capital/Total Assets	3.37%	4.01%	4.83%	4.91%
Tangible Capital/Total Assets	0.95%	1.72%	2.79%	2.80%
Net Income (Loss)	1,558,203	5,217,085	6,827,200	3,742,480
Return on Average Assets	0.22%	0.64%	0.74%	0.36%
Return on Avg. Regulatory Cap.	5.32%	14.22%	13.97%	6.33%
Yield on Loans	11.63%	11.46%	10.60%	9.62%
Yield on Investments	10.68%	9.32%	8.13%	7.94%
Yield on Earning Assets	11.50%	11.15%	10.25%	9.39%
Cost of Savings	9.95%	8.97%	7.79%	6.79%
Cost of Borrowings	10.65%	9.50%	8.65%	8.03%
Cost of Funds	10.05%	9.06%	7.94%	7.04%
Yield/Cost Spread	1.45%	2.09%	2.31%	2.35%
Amt.Elig. for Reg. Liquidity	82,799,663	89,406,621	101,921,904	88,855,059
Amt.Elig. for Reg.Liq./Tot.Assets	10.77%	10.40%	10.38%	8.03%
Int.Earn.Asst./Int.Bear.Liab.	95.34%	96.05%	97.13%	97.08%
Loans & Participations Purchased	43,387,398	44,385,847	54,827,819	55,960,438
Loans & Participations Sold	40,924,810	74,812,703	124,443,828	111,691,834
Mortg. Loans Serviced for Others	136,334,092	182,942,379	245,334,097	294,295,385
Mortg. Loans Serviced by Others	88,939,437	98,443,998	95,521,303	103,810,902
Broker Originated Deposits	33,388,872	33,760,326	36,855,549	55,075,810
Cash Div. on Preferred Stock	32,265	39,985	60,310	111,754
Cash Div. on Permanent Stock	262,394	331,518	530,374	990,262
Cash Div. on Other Cap. Inst.	361	4,605	17,461	78,532
Non 1-4 Con./Conv.Lns./Tot.Asst	15.43%	17.39%	17.20%	16.84%
Balloon & Adj. Rate Loans	177,540,240	241,775,877	295,958,899	382,575,673
Ser.Corp.Inc./Inv.in Ser.Corp.	10.67%	8.90%	9.24%	4.97%
OTHER INFORMATION				
Annual Closing Date	N/A	N/A	N/A	N/A
No. of Wholly-Owned Ser. Corps.	2,568	2,874	3,198	3,472
No. of Deposit Accounts	89,131,333	89,913,355	92,535,888	96,692,128

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GAAP SOLVENT FSLIC THRIFTS
BALANCE SHEETS
(Dollars in Thousands)

ASSETS	1984	1985	1986	1987
Construction Loans On:				
1-4 Dwelling Units	$ N/A	$ N/A	$ N/A	$ 19,674,580
5 or More Dwelling Units	N/A	N/A	N/A	10,452,503
Nonresidential	N/A	N/A	N/A	15,200,115
Permanent Mortgages On:				
1-4 Dwelling Units	356,589,440	376,395,562	389,496,716	429,438,168
5 or More Dwelling Units	47,623,708	58,696,035	67,928,185	64,817,504
Nonresidential (Except Land)	59,204,868	73,680,055	81,186,237	75,356,613
Dev. Bldg. Lots, Land, Etc.	11,815,556	17,161,615	19,713,802	20,676,872
Mortgage Backed Securities	92,124,697	100,855,779	143,851,787	184,103,109
Accrued Interest Receivable	5,476,874	6,450,572	7,054,907	7,861,768
Other Mortgage Receivables	19,271,680	18,204,978	20,313,787	1,866,166
Loans in Process	(17,173,432)	(19,646,957)	(19,632,899)	(20,098,128)
Unearned Disc. & Def. Loan Fees	(12,060,174)	(10,080,355)	(7,715,882)	(8,091,969)
Specific Reserves & Val. Allow.	(1,820,166)	(2,183,490)	(3,338,341)	(4,821,025)
Net Mortgage Loans	561,053,066	619,533,796	698,858,292	796,436,277
Commercial Loans	8,360,015	11,905,958	18,332,097	19,013,911
Consumer Loans	25,428,585	34,365,527	41,006,123	48,989,804
Financing Leases	244,128	484,311	516,405	860,841
Accrued Interest Receivable	441,112	564,443	665,182	702,039
Loans in Process	(496,385)	(484,988)	(513,671)	(625,231)
Unearned Disc. & Def. Loan Fees	(521,040)	(758,801)	(875,914)	(755,273)
Specific Reserves & Val. Allow.	(162,313)	(357,129)	(613,140)	(908,526)
Net Nonmortgage Loans	33,294,091	45,719,353	58,517,067	67,277,587
Repossessed Assets	3,505,825	5,636,714	7,891,556	11,147,507
Valuation Allowances	(479,394)	(821,840)	(1,291,773)	(2,000,403)
Net Repossessed Assets	3,026,431	4,814,874	6,599,783	9,147,104
Real Estate Held For Dev., Etc.	3,965,834	4,549,596	5,209,389	5,248,651
Valuation Allowances	(79,551)	(180,034)	(203,069)	(440,325)
Net Real Estate Held for Dev.	3,886,283	4,369,562	5,006,320	4,808,326
Cash & Demand Deposits	9,178,187	11,084,728	14,854,484	14,195,519
U.S. Govt. & Agency Securities	36,855,393	34,337,857	39,415,495	45,449,551
Equity Sec., Except FHLB/FHLMC	N/A	1,107,728	1,119,461	1,184,572
Other Investments	61,790,380	72,110,635	84,686,627	88,160,936
Accrued Interest Receivable	1,579,763	1,443,524	1,412,084	1,702,791
Valuation Allowances	(22,749)	(46,810)	(127,901)	(313,162)
Net Cash & Investment Sec.	109,380,974	120,037,662	141,360,250	150,380,207
Net Fixed Assets	9,437,471	10,586,708	12,244,667	13,548,948
Investment in Ser. Corps./Subs.	10,992,625	14,012,297	15,142,561	18,140,434
Deferred Net Losses (Gains)	3,316,320	3,492,442	3,092,043	2,574,947
Intangible Assets	18,583,123	19,668,948	20,067,453	23,450,581
Other Assets	15,714,892	17,701,555	20,557,612	21,433,911
TOTAL ASSETS	$ 768,685,308	$ 859,937,317	$ 981,446,164	$1,107,198,334

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GAAP SOLVENT FSLIC THRIFTS
BALANCE SHEETS
(Dollars in Thousands)

LIABILITIES	1984	1985	1986	1987
Fixed-Maturity Deposits	$ 451,691,208	$ 480,429,250	$ 503,049,595	$ 566,900,284
Transaction Accounts	22,003,698	29,086,018	43,836,515	49,987,540
Money Market Deposit Accounts	86,046,491	105,510,507	117,955,173	104,959,528
Passbook Accounts	51,482,430	52,954,592	68,945,118	78,922,582
Total Savings Deposits	611,223,827	667,980,367	733,786,401	800,769,934
FHLB Advances	56,293,076	66,608,273	81,279,474	99,555,454
Repurchase Agreements	40,833,238	41,806,775	56,024,255	80,762,445
Commercial Paper Issued	296,576	695,849	774,956	2,129,725
Sub.Deb. not Qual. as Reg.Cap.	575,632	620,422	209,013	161,440
Mortgage-Backed Bonds Issued	4,185,620	7,621,007	11,552,856	14,480,929
Other Borrowings	9,246,271	14,566,068	21,097,649	27,619,735
Other Liabilities	14,447,001	18,225,097	20,794,001	19,421,408
TOTAL LIABILITIES	737,101,264	818,123,996	925,518,638	1,044,901,211
REGULATORY CAPITAL				
Preferred Stock	198,710	202,136	243,495	921,782
Permanent Stock	701,340	941,505	1,212,344	1,543,667
Contributed Capital	6,453,459	10,042,676	16,787,652	19,409,551
Qualifying Mutual Cap. Cert.	5,516	3,106	4,841	5,943
Qualifying Subordinated Deb.	826,460	1,738,085	3,124,278	3,515,419
Appraised Equity Capital	908,704	1,164,641	1,616,773	1,482,615
Net Worth & Income Cap. Cert.	807,011	1,163,033	845,693	488,295
Retained Earnings (Deficit)	21,682,826	26,558,098	32,092,450	34,929,845
TOTAL REGULATORY CAPITAL	31,584,044	41,813,315	55,927,520	62,297,114
TOTAL LIAB. & REG. CAPITAL	$ 768,685,308	$ 859,937,318	$ 981,446,156	$1,107,198,329

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GAAP SOLVENT FSLIC THRIFTS
STATEMENTS OF OPERATIONS
(Dollars in Thousands)

	1984	1985	1986	1987
Interest Income	$ 72,241,860	$ 81,314,457	$ 84,594,958	$ 88,074,423
Interest Expense	65,605,845	68,833,146	67,673,831	67,919,369
Net Interest Inc. (Exp.)	6,636,015	12,481,311	16,921,127	20,155,054
Other Operating Income:				
Mortgage Loan Fees	2,613,754	2,743,926	3,289,818	3,044,260
Loan Servicing Fees	352,492	521,421	734,765	951,373
Other Loan Fees & Charges	592,531	737,567	958,043	938,043
Ser.Chgs. & Fees - Trans.Accts.	321,530	474,673	609,162	738,945
Service Corps./Subsidiaries	854,271	1,112,655	1,346,503	827,244
Other	1,595,261	1,494,206	2,054,291	1,396,339
Total Oth. Operating Income	6,329,839	7,084,448	8,992,582	7,896,204
Operating Expense:				
Officers & Employees Comp.	4,873,618	5,847,850	7,084,982	8,189,944
Legal Expense	130,874	169,829	243,579	290,850
Office Occ. & Equip. Expense	2,405,579	2,827,412	3,366,779	3,820,144
Marketing Expense	613,878	657,035	724,412	834,619
Professional Services	264,946	358,367	408,237	489,421
Amortization of Goodwill	633,395	806,280	878,262	1,007,944
Other	2,731,303	4,364,546	5,153,980	5,672,883
Total Operating Expense	11,653,593	15,031,319	17,860,231	20,305,805
NET OPER. INCOME (DEFICIT)	1,312,261	4,534,440	8,053,478	7,745,453
Non-Operating Income:				
Profit on Sale of REO & Other	407,296	389,885	398,074	470,288
Profit on Sale of Investments	554,745	1,567,782	2,157,246	1,205,216
Profit on Sale of Loans	1,101,697	2,911,025	3,972,264	2,407,830
Amortized Deferred Gains	37,222	68,678	48,867	41,660
Other	897,347	618,009	652,654	952,867
Total Non-Operating Income	2,998,307	5,555,379	7,229,105	5,077,861
Non-Operating Expense:				
Provision for Losses on Assets	N/A	N/A	N/A	3,235,243
Loss on Sale of REO & Other	510,105	631,591	1,036,176	474,524
Loss on Sale of Investments	201,982	337,983	504,772	572,062
Loss on Sale of Loans	906,548	1,086,738	2,385,391	646,081
Amortized Deferred Losses	122,085	193,200	232,249	215,897
Other	274,470	387,397	898,224	1,116,416
Total Non-Operating Expense	2,015,190	2,636,909	5,056,812	6,260,223
INCOME (LOSS) BEF. TAXES & ADJ.	2,295,378	7,452,910	10,225,771	6,563,091
Income Taxes (Credits)	690,699	2,034,377	3,207,853	2,722,627
NET INCOME (LOSS) BEFORE ADJ.	1,603,438	5,417,640	7,017,807	3,840,303
Prior Period Adjustments	(45,228)	(200,570)	(190,594)	(97,826)
ADJUSTED NET INCOME (LOSS)	$ 1,558,203	$ 5,217,085	$ 6,827,200	$ 3,742,480

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05/15/88

GAAP SOLVENT FSLIC THRIFTS
SELECTED FINANCIAL INFORMATION AT DECEMBER 31, 1987
(Dollars in Thousands)

Institution Name	Total Assets	Regulatory Capital	Reg. Cap./ Assets	Estimated GAAP Cap.	Est. GAAP Capital/ Assets	Tangible Capital	Tangible Capital/ Assets	Int.Earn. Asst/Int. Bear.Liab	Non 1-4 Con/Conv Lns/Assts	Net Repos Assets/ Tot Asst	Serv.Corp Inv./ Tot Asst	Net Oper. Income (Deficit)	Net Op. Inc (Def)/ Avg Asst	Adjusted Net Income (Loss)	Adj. Net Inc(Loss)/ Avg Asst
CT Totals, 27 Institutions	12,574,468	819,389	6.52	769,379	6.12	535,704	4.26	101.79	5.54	0.17	0.33	60,075	0.52	39,617	0.34
ME Totals, 15 Institutions	1,468,697	109,218	7.44	106,845	7.27	66,364	4.52	100.63	4.99	0.11	0.07	13,817	1.03	11,557	0.86
MA Totals, 33 Institutions	9,200,596	619,283	6.73	572,577	6.22	383,782	4.17	96.18	12.07	0.03	1.41	87,331	1.09	72,565	0.90
NH Totals, 12 Institutions	2,043,232	180,255	8.82	177,129	8.67	162,987	7.98	105.12	10.51	0.08	0.63	21,006	1.09	12,943	0.67
RI Totals, 4 Institutions	4,074,779	263,750	6.47	257,951	6.33	170,663	4.19	93.17	37.23	1.24	6.19	35,787	0.93	341	0.01
VT Totals, 4 Institutions	516,303	31,177	6.04	29,266	5.67	26,351	5.10	98.40	6.59	0.12	0.47	4,954	1.05	3,904	0.83
NJ Totals, 122 Institutions	49,509,786	2,660,876	5.37	2,346,636	4.74	1,334,777	2.70	97.98	11.93	0.36	0.83	501,223	1.05	256,492	0.54
NY Totals, 80 Institutions	53,393,367	2,948,620	5.52	2,458,549	4.60	(25,562)	(0.05)	96.08	12.23	0.26	0.91	433,047	0.87	310,689	0.63
PR Totals, 9 Institutions	6,206,407	436,143	7.03	325,553	5.25	289,427	4.66	102.80	8.91	0.17	0.63	73,592	1.25	49,680	0.84
DE Totals, ~~4~~ Institutions	435,235	12,328	2.83	10,805	2.48	(2,715)	(0.62)	95.61	6.26	0.03	0.43	975	0.25	(234)	(0.06)
PA Totals, 164 Institutions	39,663,293	2,343,108	5.91	2,125,121	5.36	1,123,160	2.83	98.39	10.09	0.38	1.02	411,091	1.10	214,530	0.57
WV Totals, 16 Institutions	1,847,738	99,381	5.38	94,221	5.10	53,193	2.88	95.10	13.67	1.93	1.07	4,093	0.22	(12,456)	(0.66)
AL Totals, 30 Institutions	7,506,068	403,020	5.37	353,179	4.71	233,406	3.11	98.57	12.89	0.82	1.02	38,201	0.53	21,776	0.30
DC Totals, 6 Institutions	4,426,407	272,535	6.16	212,669	4.80	84,048	1.90	100.23	10.68	0.11	0.82	2,786	0.06	1,378	0.03
FL Totals, 127 Institutions	74,247,828	3,946,302	5.32	3,583,500	4.83	2,042,404	2.75	96.28	13.83	0.75	2.23	342,017	0.48	201,256	0.28
GA Totals, 60 Institutions	17,176,811	906,252	5.28	813,391	4.74	517,267	3.01	98.14	14.03	0.67	0.98	143,542	0.89	70,604	0.44
MD Totals, 89 Institutions	17,688,382	1,087,630	6.15	865,956	4.90	614,323	3.47	99.53	16.87	0.34	0.66	199,162	1.22	119,982	0.73
NC Totals, 131 Institutions	18,326,397	1,244,033	6.79	1,148,185	6.27	984,359	5.37	100.98	14.00	0.35	0.69	262,646	1.48	141,215	0.79
SC Totals, 46 Institutions	9,431,282	547,847	5.81	483,910	5.13	358,752	3.80	98.31	15.18	0.57	0.74	100,880	1.10	54,365	0.59
VA Totals, 58 Institutions	23,012,754	1,475,091	6.41	1,172,551	5.10	728,257	3.16	97.37	20.40	0.71	1.76	132,579	0.61	106,182	0.49
KY Totals, 63 Institutions	7,167,921	477,596	6.66	441,595	6.16	407,730	5.69	101.65	8.65	0.28	0.91	74,391	1.06	38,123	0.55
OH Totals, 206 Institutions	46,753,183	2,743,989	5.87	2,433,899	5.21	1,499,330	3.21	98.63	14.61	0.49	1.11	462,964	1.01	281,015	0.61
TN Totals, 55 Institutions	10,619,731	834,940	7.86	734,354	6.91	576,673	5.43	100.87	12.79	0.44	1.01	135,335	1.32	71,731	0.70
IN Totals, 99 Institutions	12,324,908	855,269	6.94	811,622	6.59	646,601	5.25	101.37	8.26	0.46	0.25	130,064	1.10	60,907	0.52

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GAAP SOLVENT FSLIC THRIFTS
SELECTED FINANCIAL INFORMATION AT DECEMBER 31, 1987
(Dollars in Thousands)

Institution Name	Total Assets	Regulatory Capital	Reg. Cap./ Assets	Estimated GAAP Cap.	Est. GAAP Capital/ Assets	Tangible Capital	Tangible Capital/ Assets	Int.Earn. Asst/Int. Bear.Liab	Non 1-4 Con/Conv Lns/Assts	Net Repos Assets/ Tot Asst	Serv.Corp Inv./ Tot Asst	Net Oper. Income (Deficit)	Net Op. Inc (Def)/ Avg Asst	Adjusted Net Income (Loss)	Adj. Net Inc(Loss)/ Avg Asst
MI Totals, 45 Institutions	35,599,558	1,887,959	5.30	1,538,449	4.32	1,065,138	2.99	100.73	6.00	0.15	0.25	218,613	0.64	183,997	0.54
IL Totals, 207 Institutions	57,611,258	4,600,657	7.99	4,132,070	7.17	2,487,348	4.32	100.80	10.23	0.51	0.99	601,131	1.08	371,363	0 67
WI Totals, 73 Institutions	16,053,927	1,120,988	6.98	1,096,535	6.83	1,044,036	6.50	102.27	13.59	0.74	0.82	176,923	1.15	93,064	0.61
IA Totals, 41 Institutions	7,400,012	275,680	3.73	197,911	2.67	92,110	1.24	95.93	17.55	1.68	0.72	42,885	0.58	(17,709)	(0.24)
MN Totals, 27 Institutions	11,729,930	439,023	3.74	316,016	2.69	136,211	1.16	94.59	12.32	0.61	1.38	(10,784)	(0.09)	(49,210)	(0.42)
MO Totals, 71 Institutions	18,066,132	961,917	5.32	803,849	4.45	658,303	3.64	100.20	12.96	0.99	0.67	166,957	1.00	88,516	0.53
ND Totals, 4 Institutions	4,013,024	203,170	5.06	144,580	3.60	5,047	0.13	95.65	10.78	0.79	1.29	15,765	0.41	17,209	0.45
SD Totals, 10 Institutions	1,264,149	62,091	4.91	50,910	4.03	26,830	2.12	97.90	19.61	1.12	0.16	18,352	1.48	3,198	0.26
AR Totals, 23 Institutions	2,394,436	105,936	4.42	90,112	3.76	48,409	2.02	95.67	14.56	1.49	0.77	17,626	0.78	6,584	0.29
LA Totals, 68 Institutions	11,456,651	1,331,785	11.62	1,265,268	11.04	746,746	6.52	98.40	23.44	2.52	3.76	22,022	0.21	(74,959)	(0.70)
MS Totals, 33 Institutions	3,951,011	243,090	6.15	192,264	4.87	131,690	3.33	93.24	15.88	1.46	3.64	29,186	0.78	17,032	0.46
NM Totals, 19 Institutions	3,874,351	184,945	4.77	142,847	3.69	96,538	2.49	93.02	12.26	2.39	2.44	45,096	1.19	14,048	0.37
TX Totals, 153 Institutions	52,401,487	2,204,336	4.21	1,788,489	3.41	(284,372)	(0.54)	85.24	27.39	4.08	4.79	(267,241)	(0.54)	(510,306)	(1.03)
CO Totals, 29 Institutions	14,189,725	682,012	4.81	597,080	4.21	551,631	3.89	97.67	28.49	1.98	1.31	(10,466)	(0.08)	(26,329)	(0.19)
KS Totals, 65 Institutions	19,094,968	1,001,545	5.25	885,333	4.64	821,483	4.30	98.28	12.20	0.77	1.93	193,385	1.15	127,023	0.76
NE Totals, 14 Institutions	9,403,386	329,568	3.50	289,292	3.08	60,223	0.64	95.07	12.57	0.69	1.94	52,641	0.64	28,585	0.35
OK Totals, 33 Institutions	6,418,298	340,108	5.30	331,645	5.17	135,278	2.11	93.19	15.01	3.27	1.72	(8,188)	(0.13)	(72,148)	(1.16)
AZ Totals, 11 Institutions	23,297,992	1,223,862	5.25	965,657	4.16	247,218	1.06	91.31	29.97	1.38	2.07	55,003	0.25	30,192	0.14
CA Totals, 174 Institutions	336,656,677	17,306,600	5.14	14,975,712	4.45	9,191,299	2.73	96.97	21.88	0.63	2.03	2,411,183	0.77	1,193,294	0.38
NV Totals, 5 Institutions	4,622,969	269,508	5.83	262,929	5.69	123,274	2.67	97.69	15.73	1.10	0.28	57,268	1.32	30,139	0.69
AK Totals, 2 Institutions	218,801	6,552	2.99	5,311	2.43	4,995	2.28	94.43	34.61	4.14	2.44	(3,176)	(1.46)	(7,609)	(3.51)
HI Totals, 6 Institutions	5,511,169	296,760	5.38	251,200	4.56	148,309	2.69	98.91	9.04	0.97	0.82	62,339	1.36	56,019	1.22
ID Totals, 6 Institutions	902,064	69,565	7.71	43,957	4.87	43,957	4.87	99.48	11.17	0.77	0.51	8,654	0.95	1,531	0.17
MT Totals, 10 Institutions	1,084,581	91,998	8.48	87,052	8.03	87,052	8.03	103.13	12.63	1.23	0.16	13,785	1.25	5,780	0.53

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GAAP SOLVENT FSLIC THRIFTS
SELECTED FINANCIAL INFORMATION AT DECEMBER 31, 1987
(Dollars in Thousands)

Institution Name	Total Assets	Regulatory Capital	Reg. Cap./ Assets	Estimated GAAP Cap.	Est. GAAP Capital/ Assets	Tangible Capital	Tangible Capital/ Assets	Int.Earn. Asst/Int. Bear.Liab	Non 1-4 Con/Conv Lns/Assts	Net Repos Assets/ Tot Asst	Serv.Corp Inv./ Tot Asst	Net Oper. Income (Deficit)	Net Op. Inc (Def)/ Avg Asst	Adjusted Net Income (Loss)	Adj. Net Inc(Loss)/ Avg Asst
OR Totals, 10 Institutions	8,211,081	336,507	4.10	327,615	3.99	(287,973)	(3.51)	89.31	11.65	0.87	1.45	3,912	0.05	3,057	0.04
UT Totals, 10 Institutions	4,679,270	266,897	5.70	257,988	5.51	45,102	0.96	92.81	17.48	1.04	2.04	(14,619)	(0.42)	(19,268)	(0.55)
WA Totals, 34 Institutions	16,759,625	1,083,586	6.47	1,002,714	5.98	689,475	4.11	98.44	17.66	1.20	0.69	168,634	1.08	119,690	0.77
WY Totals, 9 Institutions	621,399	36,833	5.93	28,257	4.55	28,257	4.55	96.69	6.16	2.18	0.36	4,811	0.75	542	0.08
GU Totals, 2 Institutions	94,830	15,604	16.45	13,478	14.21	7,887	8.32	103.42	13.30	0	0.42	2,198	2.42	993	1.10
Grand Totals, 2634 Institutions	1,107,198,334	62,297,114	5.63	54,413,363	4.91	30,962,782	2.80	97.08	16.84	0.83	1.64	7,745,453	0.74	3,742,480	0.36

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GAAP SOLVENT FSLIC THRIFTS
FINANCIAL RATIOS - BALANCE SHEETS
(As a Percent of Total Assets)

ASSETS	1984	1985	1986	1987
Construction Loans On:				
1-4 Dwelling Units	N/A	N/A	N/A	1.78
5 or More Dwelling Units	N/A	N/A	N/A	0.94
Nonresidential	N/A	N/A	N/A	1.37
Permanent Mortgages On:				
1-4 Dwelling Units	46.39	43.77	39.69	38.79
5 or More Dwelling Units	6.20	6.83	6.92	5.85
Nonresidential (Except Land)	7.70	8.57	8.27	6.81
Dev. Bldg. Lots, Land, Etc.	1.54	2.00	2.01	1.87
Mortgage Backed Securities	11.98	11.73	14.66	16.63
Accrued Interest Receivable	0.71	0.75	0.72	0.71
Other Mortgage Receivables	2.51	2.12	2.07	0.17
Loans in Process	(2.23)	(2.28)	(2.00)	(1.82)
Unearned Disc. & Def. Loan Fees	(1.57)	(1.17)	(0.79)	(0.73)
Specific Reserves & Val. Allow.	(0.24)	(0.25)	(0.34)	(0.44)
Net Mortgage Loans	72.99	72.04	71.21	71.93
Commercial Loans	1.09	1.38	1.87	1.72
Consumer Loans	3.31	4.00	4.18	4.42
Financing Leases	0.03	0.06	0.05	0.08
Accrued Interest Receivable	0.06	0.07	0.07	0.06
Loans in Process	(0.06)	(0.06)	(0.05)	(0.06)
Unearned Disc. & Def. Loan Fees	(0.07)	(0.09)	(0.09)	(0.07)
Specific Reserves & Val. Allow.	(0.02)	(0.04)	(0.06)	(0.08)
Net Nonmortgage Loans	4.33	5.32	5.96	6.08
Repossessed Assets	0.46	0.66	0.80	1.01
Valuation Allowances	(0.06)	(0.10)	(0.13)	(0.18)
Net Repossessed Assets	0.39	0.56	0.67	0.83
Real Estate Held For Dev., Etc.	0.52	0.53	0.53	0.47
Valuation Allowances	(0.01)	(0.02)	(0.02)	(0.04)
Net Real Estate Held for Dev.	0.51	0.51	0.51	0.43
Cash & Demand Deposits	1.19	1.29	1.51	1.28
U.S. Govt. & Agency Securities	4.79	3.99	4.02	4.10
Equity Sec., Except FHLB/FHLMC	N/A	0.13	0.11	0.11
Other Investments	8.04	8.39	8.63	7.96
Accrued Interest Receivable	0.21	0.17	0.14	0.15
Valuation Allowances	0.00	(0.01)	(0.01)	(0.03)
Net Cash & Investment Sec.	14.23	13.96	14.40	13.58
Net Fixed Assets	1.23	1.23	1.25	1.22
Investment in Ser. Corps./Subs.	1.43	1.63	1.54	1.64
Deferred Net Losses (Gains)	0.43	0.41	0.32	0.23
Intangible Assets	2.42	2.29	2.04	2.12
Other	2.04	2.06	2.09	1.94
TOTAL ASSETS	100.00	100.00	100.00	100.00

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GAAP SOLVENT FSLIC THRIFTS
FINANCIAL RATIOS - BALANCE SHEETS
(As a Percent of Total Assets)

LIABILITIES	1984	1985	1986	1987
Fixed-Maturity Deposits	58.76	55.87	51.26	51.20
Transaction Accounts	2.86	3.38	4.47	4.51
Money Market Deposit Accounts	11.19	12.27	12.02	9.48
Passbook Accounts	6.70	6.16	7.02	7.13
Total Savings Deposits	79.52	77.68	74.77	72.32
FHLB Advances	7.32	7.75	8.28	8.99
Repurchase Agreements	5.31	4.86	5.71	7.29
Commercial Paper Issued	0.04	0.08	0.08	0.19
Sub. Deb. not Qual. as Reg. Cap.	0.07	0.07	0.02	0.01
Mortgage-Backed Bonds Issued	0.54	0.89	1.18	1.31
Other Borrowings	1.20	1.69	2.15	2.49
Other Liabilities	1.88	2.12	2.12	1.75
TOTAL LIABILITIES	95.89	95.14	94.30	94.37
REGULATORY CAPITAL				
Preferred Stock	0.03	0.02	0.02	0.08
Permanent Stock	0.09	0.11	0.12	0.14
Contributed Capital	0.84	1.17	1.71	1.75
Qualifying Mutual Cap. Cert.	0.00	0.00	0.00	0.00
Qualifying Subordinated Deb.	0.11	0.20	0.32	0.32
Appraised Equity Capital	0.12	0.14	0.16	0.13
Net Worth & Income Cap. Cert.	0.10	0.14	0.09	0.04
Retained Earnings (Deficit)	2.82	3.09	3.27	3.15
TOTAL REGULATORY CAPITAL	4.11	4.86	5.70	5.63
TOTAL LIABILITIES & REG. CAP.	100.00	100.00	100.00	100.00

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GAAP SOLVENT FSLIC THRIFTS
FINANCIAL RATIOS - STATEMENTS OF OPERATIONS
(As a Percent of Average Assets)

	1984	1985	1986	1987
Interest Income	10.33	9.99	9.19	8.43
Interest Expense	9.39	8.45	7.35	6.50
Net Interest Inc. (Exp.)	0.95	1.53	1.84	1.93
Other Operating Income:				
Mortgage Loan Fees	0.37	0.34	0.36	0.29
Loan Servicing Fees	0.05	0.06	0.08	0.09
Other Loan Fees & Charges	0.08	0.09	0.10	0.09
Ser.Chgs. & Fees-Trans.Accts	0.05	0.06	0.07	0.07
Service Corps./Subsidiaries	0.12	0.14	0.15	0.08
Other	0.23	0.18	0.22	0.13
Total Oth. Operating Income	0.91	0.87	0.98	0.76
Operating Expense:				
Officers & Employees Comp.	0.70	0.72	0.77	0.78
Legal Expense	0.02	0.02	0.03	0.03
Office Occ. & Equip. Expense	0.34	0.35	0.37	0.37
Marketing Expense	0.09	0.08	0.08	0.08
Professional Services	0.04	0.04	0.04	0.05
Amortization of Goodwill	0.09	0.10	0.10	0.10
Other	0.39	0.54	0.56	0.54
Total Operating Expense	1.67	1.85	1.94	1.94
NET OPER. INCOME (DEFICIT)	0.19	0.56	0.87	0.74
Non-Operating Income:				
Profit on Sale of REO & Other	0.06	0.05	0.04	0.05
Profit on Sale of Investments	0.08	0.19	0.23	0.12
Profit on Sale of Loans	0.16	0.36	0.43	0.23
Amortized Deferred Gains	0.01	0.01	0.01	0.00
Other	0.13	0.08	0.07	0.09
Total Non-Operating Income	0.43	0.68	0.79	0.49
Non-Operating Expense:				
Provision for Losses on Assets	N/A	N/A	N/A	0.31
Loss on Sale of REO & Other	0.07	0.08	0.11	0.05
Loss on Sale of Investments	0.03	0.04	0.05	0.05
Loss on Sale of Loans	0.13	0.13	0.26	0.06
Amortized Deferred Losses	0.02	0.02	0.03	0.02
Other	0.04	0.05	0.10	0.11
Total Non-Operating Expense	0.29	0.32	0.55	0.60
INCOME (LOSS) BEF. TAXES & ADJ.	0.33	0.92	1.11	0.63
Income Taxes (Credits)	0.10	0.25	0.35	0.26
NET INCOME (LOSS) BEFORE ADJ.	0.23	0.67	0.76	0.37
Prior Period Adjustments	(0.01)	(0.02)	(0.02)	(0.01)
ADJUSTED NET INCOME (LOSS)	0.22	0.64	0.74	0.36

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GAAP SOLVENT FSLIC THRIFTS
QUARTERLY STATEMENTS OF OPERATIONS
(Dollars in Thousands)

	3/31/87	6/30/87	9/30/87	12/31/87
Interest Income	$ 21,001,709	$ 21,563,746	$ 22,184,103	$ 23,324,865
Interest Expense	15,963,549	16,316,101	17,187,114	18,452,605
Net Interest Inc. (Exp.)	5,038,160	5,247,645	4,996,989	4,872,260
Other Operating Income:				
Mortgage Loan Fees	649,979	899,061	772,952	722,268
Loan Servicing Fees	205,509	242,463	243,104	260,297
Other Loan Fees & Charges	223,431	253,389	235,959	225,264
Ser.Chgs. & Fees-Trans.Accts	169,148	178,424	188,076	203,297
Service Corps./Subsidiaries	264,341	322,572	152,629	87,702
Other	429,515	296,797	310,157	359,870
Total Oth. Operating Income	1,941,923	2,192,706	1,902,877	1,858,698
Operating Expense:				
Officers & Employees Comp.	1,973,235	2,021,103	2,047,001	2,148,605
Legal Expense	58,235	69,288	75,075	88,252
Office Occ. & Equip. Expense	908,461	932,993	965,694	1,012,996
Marketing Expense	188,261	218,418	201,756	226,184
Professional Services	110,151	120,698	122,167	136,405
Amortization of Goodwill	235,915	253,081	258,813	260,135
Other	1,338,840	1,421,024	1,385,038	1,527,981
Total Operating Expense	4,813,098	5,036,605	5,055,544	5,400,558
NET OPER. INCOME (DEFICIT)	2,166,985	2,403,746	1,844,322	1,330,400
Non-Operating Income:				
Profit on Sale of REO & Other	92,912	122,896	101,079	153,401
Profit on Sale of Investments	386,951	313,939	218,883	285,443
Profit on Sale of Loans	1,102,789	589,981	406,234	308,826
Amortized Deferred Gains	7,024	9,101	18,587	6,948
Other	110,916	299,970	205,168	336,813
Total Non-Operating Income	1,700,592	1,335,887	949,951	1,091,431
Non-Operating Expense:				
Provision for Losses on Assets	500,107	827,442	771,995	1,135,699
Loss on Sale of REO & Other	105,452	130,474	107,279	131,319
Loss on Sale of Investments	75,940	179,797	137,059	179,266
Loss on Sale of Loans	125,891	183,122	174,252	162,816
Amortized Deferred Losses	52,851	47,196	65,942	49,908
Other	96,650	743,832	134,202	141,732
Total Non-Operating Expense	956,891	2,111,863	1,390,729	1,800,740
INCOME (LOSS) BEF. TAXES & ADJ.	2,910,686	1,627,770	1,403,544	621,091
Income Taxes (Credits)	1,000,276	702,724	589,332	430,295
NET INCOME (LOSS) BEFORE ADJ.	1,910,316	925,017	814,124	190,846
Prior Period Adjustments	(6,571)	(12,193)	(1,650)	(77,412)
ADJUSTED NET INCOME (LOSS)	$ 1,903,749	$ 912,825	$ 812,473	$ 113,433

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GAAP SOLVENT FSLIC THRIFTS
FINANCIAL RATIOS - QUARTERLY STATEMENTS OF OPERATIONS
(As a Percent of Average Assets)

	3/31/87	6/30/87	9/30/87	12/31/87
Interest Income	8.04	8.26	8.50	8.93
Interest Expense	6.11	6.25	6.58	7.07
Net Interest Inc. (Exp.)	1.93	2.01	1.91	1.87
Other Operating Income:				
Mortgage Loan Fees	0.25	0.34	0.30	0.28
Loan Servicing Fees	0.08	0.09	0.09	0.10
Other Loan Fees & Charges	0.09	0.10	0.09	0.09
Ser.Chgs. & Fees-Trans.Accts	0.06	0.07	0.07	0.08
Service Corps./Subsidiaries	0.10	0.12	0.06	0.03
Other	0.16	0.11	0.12	0.14
Total Other Oper. Income	0.74	0.84	0.73	0.71
Operating Expense:				
Officers & Employees Comp.	0.76	0.77	0.78	0.82
Legal Expense	0.02	0.03	0.03	0.03
Office Occ. & Equip. Expense	0.35	0.36	0.37	0.39
Marketing Expense	0.07	0.08	0.08	0.09
Professional Services	0.04	0.05	0.05	0.05
Amortization of Goodwill	0.09	0.10	0.10	0.10
Other	0.51	0.54	0.53	0.59
Total Operating Expense	1.84	1.93	1.94	2.07
NET OPER. INCOME (DEFICIT)	0.83	0.92	0.71	0.51
Non-Operating Income:				
Profit on Sale of REO & Other	0.04	0.05	0.04	0.06
Profit on Sale of Investments	0.15	0.12	0.08	0.11
Profit on Sale of Loans	0.42	0.23	0.16	0.12
Amortized Deferred Gains	0.00	0.00	0.01	0.00
Other	0.04	0.11	0.08	0.13
Total Non-Operating Income	0.65	0.51	0.36	0.42
Non-Operating Expense:				
Provision for Losses on Assets	0.19	0.32	0.30	0.43
Loss on Sale of REO & Other	0.04	0.05	0.04	0.05
Loss on Sale of Investments	0.03	0.07	0.05	0.07
Loss on Sale of Loans	0.05	0.07	0.07	0.06
Amortized Deferred Losses	0.02	0.02	0.03	0.02
Other	0.04	0.28	0.05	0.05
Total Non-Operating Expense	0.37	0.81	0.53	0.69
INCOME (LOSS) BEF. TAXES & ADJ.	1.11	0.62	0.54	0.24
Income Taxes (Credits)	0.38	0.27	0.23	0.16
NET INCOME (LOSS) BEFORE ADJ.	0.73	0.35	0.31	0.07
Prior Period Adjustments	(0.00)	(0.00)	(0.00)	(0.03)
ADJUSTED NET INCOME (LOSS)	0.73	0.35	0.31	0.04

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GAAP SOLVENT FSLIC THRIFTS
HISTORICAL & FORECASTED BALANCE SHEETS

(Dollars in Thousands)

	HISTORICAL			FORECASTED			
	1984	1985	1986	1987	1988	1989	1990
ASSETS							
Earning Assets	$ 688,978,841	$ 768,275,283	$ 878,746,308	$ 995,564,674	$1,052,636,276	$1,113,163,147	$1,177,356,456
Non-Earning Assets	79,706,467	91,662,034	102,699,856	111,633,660	111,912,744	112,192,526	112,473,007
TOTAL ASSETS	$ 768,685,308	$ 859,937,317	$ 981,446,164	$1,107,198,334	$1,164,549,020	$1,225,355,673	$1,289,829,463
LIABILITIES							
Interest Bearing Liab.	$ 722,654,238	$ 799,892,835	$ 904,724,628	$1,025,486,383	$1,076,760,702	$1,130,598,737	$1,187,128,674
Non-Interest Bearing Liab.	14,447,026	18,225,161	20,794,010	19,421,487	20,392,561	21,412,189	22,482,799
TOTAL LIABILITIES	737,101,264	818,123,996	925,518,638	1,044,907,870	1,097,153,263	1,152,010,926	1,209,611,473
REGULATORY CAPITAL							
Preferred Stock	198,710	202,136	243,495	921,782	921,782	921,782	921,782
Perm. Stock & Cont. Cap.	7,154,799	10,984,181	17,999,996	20,953,218	20,953,218	20,953,218	20,953,218
Qualif. Subordinated Deb.	831,976	1,741,191	3,129,119	3,515,419	3,515,419	3,515,419	3,515,419
Appraised Equity Capital	908,704	1,164,641	1,616,773	1,482,615	1,482,615	1,482,615	1,482,615
Net Worth & Income Cap. Cert.	807,011	1,163,033	845,693	488,295	488,295	488,295	488,295
Retained Earnings (Deficit)	21,682,826	26,558,098	32,092,450	36,109,683	41,214,976	47,163,966	54,037,209
Dividends Paid	(295,020)	(376,108)	(608,145)	(1,180,548)	(1,180,548)	(1,180,548)	(1,180,548)
TOTAL REGULATORY CAPITAL	31,584,044	41,813,315	55,927,520	62,290,464	67,395,757	73,344,747	80,217,990
TOTAL LIABS. & REG. CAP.	$ 768,685,308	$ 859,937,318	$ 981,446,156	$1,107,198,334	$1,164,549,020	$1,225,355,673	$1,289,829,463

HISTORICAL & FORECASTED SELECTED FINANCIAL HIGHLIGHTS

	HISTORICAL			FORECASTED			
	1984	1985	1986	1987	1988	1989	1990
Average Assets	$ 699,033,415	$ 814,311,313	$ 920,691,741	$1,044,322,249	$1,135,873,677	$1,194,952,347	$1,257,592,568
% Change in Assets	22.13	11.87	14.13	12.81	5.18	5.22	5.26
Reg. Capital/Total Assets	4.11	4.86	5.70	5.63	5.79	5.99	6.22
Return on Average Assets	0.22	0.64	0.74	0.47	0.55	0.60	0.64
Return on Average Reg. Cap.	5.32	14.22	13.97	8.33	9.69	10.13	10.49
Yield on Earning Assets	11.50	11.15	10.25	9.40	9.39	9.39	9.39
Cost of Funds	10.05	9.06	7.94	7.04	7.04	7.04	7.04
Yield/Cost Spread	1.45	2.09	2.31	2.36	2.35	2.35	2.35
Int.Earn.Asst./Int.Bear.Liab.	95.34	96.05	97.13	97.08	97.76	98.46	99.18

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GAAP SOLVENT FSLIC THRIFTS
HISTORICAL & FORECASTED STATEMENTS OF OPERATIONS
(Dollars in Thousands)

	HISTORICAL			FORECASTED			
	1984	1985	1986	1987	1988	1989	1990
Interest Income	$ 72,241,860	$ 81,314,457	$ 84,594,958	$ 88,074,423	$ 96,123,095	$ 101,642,050	$ 107,495,230
Interest Expense	65,605,845	68,833,146	67,673,831	67,919,369	74,044,296	77,746,510	81,633,836
Net Interest Inc. (Exp.)	6,636,015	12,481,311	16,921,127	20,155,054	22,078,799	23,895,539	25,861,394
Other Operating Income:							
Mortgage Loan Fees	2,613,754	2,743,926	3,289,818	3,044,260	3,311,072	3,483,286	3,665,882
Loan Servicing Fees	352,492	521,421	734,765	951,373	1,034,781	1,088,602	1,145,667
Other Loan Fees & Charges	592,531	737,567	958,043	938,043	1,020,015	1,073,067	1,129,318
Ser.Chg. & Fees-Trans.Accts.	321,530	474,673	609,162	738,945	804,199	846,026	890,376
Service Corps./Subsidiaries	854,271	1,112,655	1,346,503	827,244	827,244	827,244	827,244
Other	1,595,261	1,494,206	2,054,291	1,396,339	1,518,663	1,597,651	1,681,401
Total Oth. Operating Inc.	6,329,839	7,084,448	8,992,582	7,896,204	8,515,973	8,915,876	9,339,888
Operating Expense:							
Officers & Employees Comp.	4,873,618	5,847,850	7,084,982	8,189,944	8,907,521	9,370,816	9,862,041
Legal Expense	130,874	169,829	243,579	290,850	316,909	333,392	350,848
Office Occ. & Equip. Exp.	2,405,579	2,827,412	3,366,779	3,820,144	4,155,026	4,371,136	4,600,274
Marketing Expense	613,878	657,035	724,412	834,619	907,563	954,767	1,004,816
Professional Services	264,946	358,367	408,237	489,421	532,725	560,433	589,811
Amortization of Goodwill	633,395	806,280	878,262	1,007,944	1,007,944	1,007,944	1,007,944
Other	2,731,303	4,364,546	5,153,980	5,672,883	6,170,066	6,490,981	6,831,243
Total Operating Expense	11,653,593	15,031,319	17,860,231	20,305,805	21,997,754	23,089,468	24,246,997
NET OPER. INC. (DEFICIT)	1,312,261	4,534,440	8,053,478	7,745,453	8,597,018	9,721,947	10,954,285
Non-Operating Income:							
Profit on Sales of REO & Oth	407,296	389,885	398,074	470,288	0	0	0
Profit on Sale of Investments	554,745	1,567,782	2,157,246	1,205,216	0	0	0
Profit on Sale of Loans	1,101,697	2,911,025	3,972,264	2,407,830	0	0	0
Amortized Deferred Gains	37,222	68,678	48,867	41,660	0	0	0
Other	897,347	618,009	652,654	952,867	0	0	0
Total Non-Operating Inc.	2,998,307	5,555,379	7,229,105	5,077,861	0	0	0
Non-Operating Expense:							
Prov. for Losses on Assets	N/A	N/A	N/A	3,235,243	0	0	0
Loss on Sale of REO & Other	510,105	631,591	1,036,176	474,524	0	0	0
Loss on Sale of Investments	201,982	337,983	504,772	572,062	0	0	0
Loss on Sale of Loans	906,548	1,086,738	2,385,391	646,081	0	0	0
Amortized Deferred Losses	122,085	193,200	232,249	215,897	215,897	215,897	215,897
Other	274,470	387,397	898,224	1,116,416	0	0	0
Total Non-Operating Exp.	2,015,190	2,636,909	5,056,812	6,260,223	215,897	215,897	215,897
INC.(LOSS) BEF. TAXES & ADJ.	2,295,378	7,452,910	10,225,771	6,563,091	8,381,121	9,506,050	10,738,348
Income Taxes (Credits)	690,699	2,034,377	3,207,853	1,640,773	2,095,280	2,376,513	2,684,557
NET INCOME (LOSS) BEF. ADJ.	1,603,438	5,417,640	7,017,807	4,922,318	6,285,841	7,129,538	8,053,791
Prior Period Adjustments	(45,228)	(200,570)	(190,594)	0	0	0	0
ADJUSTED NET INCOME (LOSS)	$ 1,558,203	$ 5,217,085	$ 6,827,200	$ 4,922,318	$ 6,285,841	$ 7,129,538	$ 8,053,791

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GAAP SOLVENT FSLIC THRIFTS
HISTORICAL & FORECASTED FINANCIAL RATIOS - BALANCE SHEETS
(As a Percent of Total Assets)

	HISTORICAL			FORECASTED			
	1984	1985	1986	1987	1988	1989	1990
ASSETS							
Earning Assets	89.63	89.34	89.54	89.92	90.39	90.84	91.28
Non-Earning Assets	10.37	10.66	10.46	10.08	9.61	9.16	8.72
TOTAL ASSETS	100.00	100.00	100.00	100.00	100.00	100.00	100.00
LIABILITIES							
Interest Bearing Liab.	94.01	93.02	92.18	92.62	92.46	92.27	92.04
Non-Interest Bearing Liab.	1.88	2.12	2.12	1.75	1.75	1.75	1.74
TOTAL LIABILITIES	95.89	95.14	94.30	94.37	94.21	94.01	93.78
REGULATORY CAPITAL							
Preferred Stock	0.03	0.02	0.02	0.08	0.08	0.08	0.07
Perm. Stock & Cont. Cap.	0.93	1.28	1.83	1.89	1.80	1.71	1.62
Qualif. Subordinated Deb.	0.11	0.20	0.32	0.32	0.30	0.29	0.27
Appraised Equity Capital	0.12	0.14	0.16	0.13	0.13	0.12	0.11
Net Worth & Income Cap. Cert.	0.10	0.14	0.09	0.04	0.04	0.04	0.04
Retained Earnings (Deficit)	2.82	3.09	3.27	3.26	3.54	3.85	4.19
Dividends Paid	(0.04)	(0.04)	(0.06)	(0.11)	(0.10)	(0.10)	(0.09)
TOTAL REGULATORY CAPITAL	4.11	4.86	5.70	5.63	5.79	5.99	6.22
TOTAL LIABS. & REG. CAP.	100.00	100.00	100.00	100.00	100.00	100.00	100.00

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GAAP SOLVENT FSLIC THRIFTS
HISTORICAL & FORECASTED FINANCIAL RATIOS - STATEMENTS OF OPERATIONS
(As a Percent of Average Assets)

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	HISTORICAL			FORECASTED			
	1984	1985	1986	1987	1988	1989	1990
Interest Income	10.33	9.99	9.19	8.43	8.46	8.51	8.55
Interest Expense	9.39	8.45	7.35	6.50	6.52	6.51	6.49
Net Interest Inc. (Exp.)	0.95	1.53	1.84	1.93	1.94	2.00	2.06
Other Operating Income:							
Mortgage Loan Fees	0.37	0.34	0.36	0.29	0.29	0.29	0.29
Loan Servicing Fees	0.05	0.06	0.08	0.09	0.09	0.09	0.09
Other Loan Fees & Charges	0.08	0.09	0.10	0.09	0.09	0.09	0.09
Ser.Chg. & Fees-Trans.Accts.	0.05	0.06	0.07	0.07	0.07	0.07	0.07
Service Corps./Subsidiaries	0.12	0.14	0.15	0.08	0.07	0.07	0.07
Other	0.23	0.18	0.22	0.13	0.13	0.13	0.13
Total Oth. Operating Inc.	0.91	0.87	0.98	0.76	0.75	0.75	0.74
Operating Expense:							
Officers & Employees Comp.	0.70	0.72	0.77	0.78	0.78	0.78	0.78
Legal Expense	0.02	0.02	0.03	0.03	0.03	0.03	0.03
Office Occ. & Equip. Exp.	0.34	0.35	0.37	0.37	0.37	0.37	0.37
Marketing Expense	0.09	0.08	0.08	0.08	0.08	0.08	0.08
Professional Services	0.04	0.04	0.04	0.05	0.05	0.05	0.05
Amortization of Goodwill	0.09	0.10	0.10	0.10	0.09	0.08	0.08
Other	0.39	0.54	0.56	0.54	0.54	0.54	0.54
Total Operating Expense	1.67	1.85	1.96	1.96	1.96	1.93	1.93
NET OPER. INC. (DEFICIT)	0.19	0.56	0.87	0.74	0.76	0.81	0.87
Non-Operating Income:							
Profit on Sales of REO & Oth	0.06	0.05	0.04	0.05	0.00	0.00	0.00
Profit on Sale of Investments	0.08	0.19	0.23	0.12	0.00	0.00	0.00
Profit on Sale of Loans	0.16	0.36	0.43	0.23	0.00	0.00	0.00
Amortized Deferred Gains	0.01	0.01	0.01	0.00	0.00	0.00	0.00
Other	0.13	0.08	0.07	0.09	0.00	0.00	0.00
Total Non-Operating Inc.	0.43	0.68	0.79	0.49	0.00	0.00	0.00
Non-Operating Expense:							
Prov. for Losses on Assets	N/A	N/A	N/A	0.31	0.00	0.00	0.00
Loss on Sale of REO & Other	0.07	0.08	0.11	0.05	0.00	0.00	0.00
Loss on Sale of Investments	0.03	0.04	0.05	0.05	0.00	0.00	0.00
Loss on Sale of Loans	0.13	0.13	0.26	0.06	0.00	0.00	0.00
Amortized Deferred Losses	0.02	0.02	0.03	0.02	0.02	0.02	0.02
Other	0.04	0.05	0.10	0.11	0.00	0.00	0.00
Total Non-Operating Exp.	0.29	0.32	0.55	0.60	0.02	0.02	0.02
INC.(LOSS) BEF. TAXES & ADJ.	0.33	0.92	1.11	0.63	0.74	0.80	0.85
Income Taxes (Credits)	0.10	0.25	0.35	0.16	0.18	0.20	0.21
NET INCOME (LOSS) BEFORE ADJ.	0.23	0.67	0.76	0.47	0.55	0.60	0.64
Prior Period Adjustments	(0.01)	(0.02)	(0.02)	0.00	0.00	0.00	0.00
ADJUSTED NET INCOME (LOSS)	0.22	0.64	0.74	0.47	0.55	0.60	0.64

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GAAP SOLVENT FSLIC THRIFTS
FORECAST ASSUMPTIONS
(Dollars in Thousands)

Page 5

		1987	1988	1989	1990
Total Annual Liability Growth		12.8990%	5.0000%	5.0000%	5.0000%
Chg. In Non-Earning Assets	$	0	0	0	0
Chg. In Preferred Stock Issues	$	0	0	0	0
Dividend Rate	F	0.0000%	0.0000%	0.0000%	0.0000%
Pay Yearly-1,Pass-2,Accrue-3		1	1	1	1
Repay. Preferred Stock Issues	$	0	0	0	0
Permanent Stock Infusions	$	0	0	0	0
New Subordinated Debt Issues	$	0	0	0	0
Repay. of Subordinated Debt	$	0	0	0	0
Accrual Rate - Each Issue	F	0.0000%	0.0000%	0.0000%	0.0000%
Appraised Equity Capital Adj.	$	0	0	0	0
N.W. & Inc. Capital Certifs.	$	0	0	0	0
Repay. NW. & Inc. Cap. Cert.	$	0	0	0	0
Interest Rate - Each Issue	F	0.0000%	0.0000%	0.0000%	0.0000%
Non-Cash Capital Infusion	$	0	0	0	0
Dividends Paid	$	0	1,180,548	1,180,548	1,180,548
Retained Earnings Adjustment	$	0	0	0	0
Yield on Exist. Earning Assets		9.3861%	9.3861%	9.3861%	9.3861%
Cost of Funds/Current Liabs.		7.0443%	7.0443%	7.0443%	7.0443%
SPREAD		2.3418%	2.3418%	2.3418%	2.3418%
Yield on New Earning Assets	F	9.5000%	9.3861%	9.3861%	9.3861%
Cost of Funds/New Liabilities		7.0000%	7.0443%	7.0443%	7.0443%
SPREAD		2.5000%	2.3418%	2.3418%	2.3418%
Mtg. Loan Fee/Avg. Assets		0.2915%	0.2915%	0.2915%	0.2915%
Mtg. Loans/Int.Earn.Assets		0.0000%	0.0000%	0.0000%	0.0000%
Yrs. Portfolio Amortization	#	8	8	8	N/A
Avg. Orig. Fee on New Loans		1.0000%	1.0000%	1.0000%	1.0000%
Loan Serv. Fees/Avg. Assets		0.0911%	0.0911%	0.0911%	0.0911%
Mtg. Loans Serv. for Others		$294,295,385	294,295,385	294,295,385	294,295,385
Avg. Servicing Fee Income		0.0000%	0.0000%	0.0000%	0.0000%
Oth. Loan Fees/Avg. Assets		0.0898%	0.0898%	0.0898%	0.0898%
Fee Inc.-Trans.Ac./Avg. Assets		0.0708%	0.0708%	0.0708%	0.0708%
Trans. Ac./Int. Bear. Liabs.		4.8746%	4.8746%	4.8746%	4.8746%
Transaction Account Fees		0.0000%	0.0000%	0.0000%	0.0000%
Inc. (Loss) - Serv.Corps./Subs.	$	0	827,244	827,244	827,244
Other Operating Inc./Avg. Assets		0.1337%	0.1337%	0.1337%	0.1337%
Off. & Emp. Comp./Avg. Assets		0.7842%	0.7842%	0.7842%	0.7842%
Legal Expense/Avg. Assets		0.0279%	0.0279%	0.0279%	0.0279%
Office Occ.& Equip./Avg.Assets		0.3658%	0.3658%	0.3658%	0.3658%
Marketing Exp./Avg. Assets		0.0799%	0.0799%	0.0799%	0.0799%
Profess. Serv./Avg. Assets		0.0469%	0.0469%	0.0469%	0.0469%
Amortization of Goodwill	$	0	1,007,944	1,007,944	1,007,944
Oth. Oper. Exp./Avg. Assets		0.5432%	0.5432%	0.5432%	0.5432%
Profit on Sales of REO & Oth.	$	0	0	0	0
Profit on Sales of Investments	$	0	0	0	0
Profit on Sales of Loans	$	0	0	0	0
Amortized Deferred Gain	$	0	0	0	0
Other Non-Operating Income	$	0	0	0	0
Provision for Loss - Cash	$	0	0	0	0
Provision for Loss - Non-Cash	$	0	0	0	0
Loss on Sales of REO & Other	$	0	0	0	0
Loss on Sales of Investments	$	0	0	0	0
Loss on Sales of Loans	$	0	0	0	0
Amortized Deferred Loss	$	0	215,897	215,897	215,897
Other Non-Operating Expense	$	0	0	0	0
Income Tax %		25.0000%	25.0000%	25.0000%	25.0000%

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GAAP SOLVENT FSLIC THRIFTS WITH IEA/IBL < 90%
SELECTED FINANCIAL INFORMATION AT DECEMBER 31, 1987
(Dollars in Thousands)

Institution Name	Total Assets	Regulatory Capital	Reg. Cap./ Assets	Estimated GAAP Cap.	Est. GAAP Capital/ Assets	Tangible Capital	Tangible Capital/ Assets	Int.Earn. Asst/Int. Bear.Liab	Non 1-4 Con/Conv Lns/Assts	Net Repos Assets/ Tot Asst	Serv.Corp Inv./ Tot Asst	Net Oper. Income (Deficit)	Net Op. Inc (Def)/ Avg Asst	Adjusted Net Income (Loss)	Adj. Net Inc(Loss)/ Avg Asst
ME Totals, 1 Institution	60,863	3,702	6.08	2,435	4.00	(5,280)	(8.68)	86.24	15.07	0.08	0.02	(193)	(0.32)	(179)	(0.30)
MA Totals, 1 Institution	2,832,432	191,031	6.74	187,277	6.61	85,339	3.01	87.47	4.19	0.03	3.01	15,312	0.73	37,517	1.78
NJ Totals, 4 Institutions	931,171	60,873	6.54	45,964	4.94	1,549	0.17	86.43	14.45	0.59	7.24	5,598	0.63	2,501	0.28
NY Totals, 3 Institutions	16,137,995	621,556	3.85	542,804	3.36	(948,263)	(5.88)	88.29	13.98	0.55	1.22	39,257	0.29	69,361	0.51
WV Totals, 1 Institution	547,099	708	0.13	708	0.13	(30,770)	(5.62)	81.01	10.68	3.70	2.99	(9,298)	(1.62)	(16,065)	(2.80)
FL Totals, 8 Institutions	14,784,272	638,638	4.32	606,498	4.10	(217,387)	(1.47)	87.90	8.30	0.93	5.93	19,814	0.14	61,306	0.45
GA Totals, 2 Institutions	1,101,641	23,768	2.16	23,768	2.16	(6,503)	(0.59)	89.41	20.25	3.98	4.65	(3,549)	(0.33)	421	0.04
MD Totals, 2 Institutions	1,361,018	40,672	2.99	36,844	2.71	(50,159)	(3.69)	89.22	13.00	0.44	0.43	(106)	(0.01)	13,560	1.11
NC Totals, 3 Institutions	456,065	13,867	3.04	7,310	1.60	(27,747)	(6.08)	86.91	27.71	0.51	1.97	1,016	0.23	1,945	0.43
SC Totals, 1 Institution	1,032,399	16,666	1.61	11,340	1.10	(41,283)	(4.00)	85.95	11.51	0.06	1.45	3,750	0.37	3,883	0.38
VA Totals, 2 Institutions	592,531	16,285	2.75	13,003	2.19	(37,918)	(6.40)	88.22	12.46	0.30	4.58	(509)	(0.09)	(1,561)	(0.28)
OH Totals, 2 Institutions	2,226,927	30,763	1.38	18,028	0.81	(24,104)	(1.08)	82.94	11.71	2.31	7.51	(9,690)	(0.44)	1,199	0.05
TN Totals, 2 Institutions	157,308	3,911	2.49	3,380	2.15	(97)	(0.06)	85.07	35.16	0.29	3.05	(174)	(0.11)	(2,808)	(1.80)
IN Totals, 2 Institutions	214,153	2,888	1.35	1,652	0.77	(19,094)	(8.92)	85.97	4.15	0.43	0.60	(362)	(0.17)	(1,124)	(0.52)
IL Totals, 10 Institutions	4,320,822	164,671	3.81	113,900	2.64	(344,617)	(7.98)	84.66	7.11	0.64	2.93	7,428	0.18	13,553	0.33
WI Totals, 2 Institutions	194,497	8,964	4.61	8,964	4.61	(2,900)	(1.49)	86.32	3.79	7.66	0.06	2,480	1.40	2,653	1.50
IA Totals, 1 Institution	276,620	2,362	0.85	362	0.13	(35,149)	(12.71)	70.57	17.88	4.58	5.57	(6,640)	(2.48)	(5,805)	(2.17)
AR Totals, 2 Institutions	743,034	23,030	3.10	16,925	2.28	(19,492)	(2.62)	89.81	5.15	1.16	0.62	1,480	0.22	(408)	(0.06)
LA Totals, 9 Institutions	1,476,933	39,150	2.65	25,865	1.75	(33,032)	(2.24)	86.27	20.32	6.53	0.04	(8,872)	(0.58)	(28,405)	(1.86)
MS Totals, 9 Institutions	1,464,357	78,411	5.35	60,881	4.16	6,861	0.47	82.62	22.20	2.40	8.49	8,654	0.66	6,851	0.52
NM Totals, 5 Institutions	494,878	18,641	3.77	16,406	3.32	4,535	0.92	85.15	22.48	2.72	1.90	2,787	0.58	(983)	(0.21)
TX Totals, 53 Institutions	37,744,311	1,355,071	3.59	1,063,663	2.82	(919,284)	(2.44)	80.52	30.89	4.76	6.30	(308,510)	(0.86)	(520,669)	(1.46)
CO Totals, 2 Institutions	104,016	3,521	3.39	2,374	2.28	2,369	2.28	83.87	31.50	7.04	0.13	(1,281)	(1.33)	(2,394)	(2.49)
KS Totals, 2 Institutions	337,300	5,687	1.69	5,054	1.50	(8,736)	(2.59)	82.84	22.30	7.40	0.80	(5,214)	(1.63)	(8,484)	(2.66)

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GAAP SOLVENT FSLIC THRIFTS WITH IEA/IBL < 90%
SELECTED FINANCIAL INFORMATION AT DECEMBER 31, 1987
(Dollars in Thousands)

Institution Name	Total Assets	Regulatory Capital	Reg. Cap./ Assets	Estimated GAAP Cap.	Est. GAAP Capital/ Assets	Tangible Capital	Tangible Capital/ Assets	Int.Earn. Asst/Int. Bear.Liab	Non 1-4 Con/Conv Lns/Assts	Net Repos Assets/ Tot Asst	Serv.Corp Inv./ Tot Asst	Net Oper. Income (Deficit)	Net Op. Inc (Def)/ Avg Asst	Adjusted Net Income (Loss)	Adj. Net Inc(Loss)/ Avg Asst
OK Totals, 7 Institutions	1,988,239	116,640	5.87	115,320	5.80	(29,360)	(1.48)	83.32	15.66	5.11	1.66	(13,881)	(0.74)	(40,209)	(2.15)
AZ Totals, 3 Institutions	8,430,970	327,129	3.88	201,325	2.39	14,406	0.17	84.29	27.40	1.69	2.48	27,684	0.34	28,201	0.35
CA Totals, 22 Institutions	12,173,301	574,539	4.72	482,211	3.96	325,678	2.68	79.25	36.18	1.31	13.11	(28,858)	(0.26)	43,445	0.39
AK Totals, 1 Institution	85,903	168	0.20	168	0.20	(148)	(0.17)	88.69	44.79	2.63	5.88	(3,307)	(4.18)	(6,271)	(7.93)
OR Totals, 1 Institution	2,157,515	25,568	1.19	25,568	1.19	(274,579)	(12.73)	78.03	17.82	1.87	1.71	(19,273)	(0.87)	(22,625)	(1.03)
UT Totals, 3 Institutions	523,827	35,341	6.75	35,341	6.75	9,650	1.84	79.35	23.24	2.55	7.68	(3,997)	(0.72)	(5,150)	(0.92)
WA Totals, 1 Institution	389,704	4,229	1.09	45	0.01	(44,637)	(11.45)	79.52	21.43	2.56	0.42	(1)	0.00	(1,393)	(0.36)
WY Totals, 2 Institutions	62,484	2,559	4.10	1,641	2.63	1,641	2.63	88.15	9.86	6.88	0.34	287	0.44	52	0.08
Grand Totals, 169 Institutions	115,404,585	4,451,009	3.86	3,677,024	3.19	(2,668,511)	(2.31)	83.61	22.02	2.49	5.29	(288,168)	(0.27)	(378,085)	(0.35)

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Docket
Charter
District
Branches 1,764

GAAP SOL. FSLIC THRIFTS-IEA/IBL<90%

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FINANCIAL HIGHLIGHTS
(Dollars in Thousands)

	1984	1985	1986	1987
Total Assets	$ 75,137,288	$ 87,080,886	$ 98,726,796	$ 115,404,585
% Change in Assets	43.85%	15.90%	13.37%	16.89%
Regulatory Capital	2,698,342	3,696,104	4,479,007	4,451,009
Estimated GAAP Capital	2,286,263	3,030,240	3,626,897	3,677,024
Tangible Capital	(1,705,496)	(1,526,446)	(1,057,136)	(2,668,511)
Regulatory Capital/Total Assets	3.59%	4.24%	4.54%	3.86%
Est. GAAP Capital/Total Assets	3.04%	3.48%	3.67%	3.19%
Tangible Capital/Total Assets	(2.27%)	(1.75%)	(1.07%)	(2.31%)
Net Income (Loss)	141,853	540,620	104,706	(378,085)
Return on Average Assets	0.22%	0.67%	0.11%	(0.35%)
Return on Avg. Regulatory Cap.	6.08%	16.91%	2.56%	(8.47%)
Yield on Loans	12.06%	11.94%	10.89%	9.82%
Yield on Investments	11.01%	9.87%	8.36%	8.65%
Yield on Earning Assets	11.90%	11.58%	10.48%	9.64%
Cost of Savings	10.01%	9.17%	8.07%	7.09%
Cost of Borrowings	9.85%	9.62%	9.47%	8.19%
Cost of Funds	9.98%	9.26%	8.35%	7.32%
Yield/Cost Spread	1.92%	2.32%	2.13%	2.32%
Amt.Elig. for Reg. Liquidity	6,508,502	7,751,982	7,491,738	7,352,226
Amt.Elig. for Reg.Liq./Tot.Assets	8.66%	8.90%	7.59%	6.37%
Int.Earn.Asst./Int.Bear.Liab.	87.23%	86.27%	85.09%	83.61%
Loans & Participations Purchased	4,663,121	7,399,002	10,904,574	9,044,663
Loans & Participations Sold	7,723,204	12,026,031	17,932,326	16,386,932
Mortg. Loans Serviced for Others	20,036,842	26,456,079	37,066,939	50,671,333
Mortg. Loans Serviced by Others	9,665,598	10,284,327	10,569,980	13,859,437
Broker Originated Deposits	2,928,196	4,643,949	6,823,969	10,249,832
Cash Div. on Preferred Stock	13,259	14,832	22,798	53,304
Cash Div. on Permanent Stock	35,262	58,136	22,173	34,546
Cash Div. on Other Cap. Inst.	-0-	225	4,510	1,393
Non 1-4 Con./Conv.Lns./Tot.Asst	20.56%	25.56%	25.57%	22.02%
Balloon & Adj. Rate Loans	16,459,652	22,991,057	26,885,111	31,840,466
Ser.Corp.Inc./Inv.in Ser.Corp.	9.52%	9.64%	10.37%	7.44%
OTHER INFORMATION				
Annual Closing Date	N/A	N/A	N/A	N/A
No. of Wholly-Owned Ser. Corps.	289	334	381	428
No. of Deposit Accounts	7,880,298	7,935,087	8,306,356	8,426,398

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GAAP SOL. FSLIC THRIFTS-IEA/IBL<90%
BALANCE SHEETS
(Dollars in Thousands)

ASSETS	1984	1985	1986	1987
Construction Loans On:				
1-4 Dwelling Units	$ N/A	$ N/A	$ N/A	$ 1,649,291
5 or More Dwelling Units	N/A	N/A	N/A	1,471,432
Nonresidential	N/A	N/A	N/A	2,223,479
Permanent Mortgages On:				
1-4 Dwelling Units	26,364,033	25,060,469	25,922,834	27,239,327
5 or More Dwelling Units	5,334,034	6,877,968	7,475,657	6,376,276
Nonresidential (Except Land)	6,570,252	8,639,614	9,384,428	7,399,354
Dev. Bldg. Lots, Land, Etc.	3,541,397	6,740,061	8,381,811	7,941,121
Mortgage Backed Securities	7,422,831	8,240,793	9,734,400	17,107,714
Accrued Interest Receivable	639,683	803,802	928,863	1,070,815
Other Mortgage Receivables	1,641,461	1,577,139	2,139,024	587,120
Loans in Process	(2,884,215)	(3,631,521)	(3,407,205)	(2,821,399)
Unearned Disc. & Def. Loan Fees	(1,908,055)	(1,754,023)	(1,388,481)	(1,321,267)
Specific Reserves & Val. Allow.	(271,286)	(318,943)	(580,726)	(989,733)
Net Mortgage Loans	46,450,148	52,235,353	58,590,618	67,933,534
Commercial Loans	1,556,866	2,334,289	3,486,506	3,129,720
Consumer Loans	3,355,558	4,151,742	4,585,667	5,694,455
Financing Leases	76,064	100,702	108,722	119,322
Accrued Interest Receivable	92,319	83,376	116,139	122,651
Loans in Process	(50,246)	(202,992)	(111,935)	(60,517)
Unearned Disc. & Def. Loan Fees	(122,643)	(139,931)	(125,519)	(87,796)
Specific Reserves & Val. Allow.	(35,916)	(55,666)	(106,204)	(142,623)
Net Nonmortgage Loans	4,872,001	6,271,522	7,953,392	8,775,212
Repossessed Assets	515,439	963,254	1,929,410	3,316,378
Valuation Allowances	(42,042)	(118,577)	(218,842)	(445,648)
Net Repossessed Assets	473,397	844,677	1,710,568	2,870,730
Real Estate Held For Dev., Etc.	1,276,623	1,678,839	2,244,436	2,223,113
Valuation Allowances	(19,013)	(23,569)	(50,243)	(193,439)
Net Real Estate Held for Dev.	1,257,610	1,655,270	2,194,193	2,029,674
Cash & Demand Deposits	1,319,288	1,448,297	1,622,639	1,770,085
U.S. Govt. & Agency Securities	3,473,619	2,573,306	3,554,026	4,707,355
Equity Sec., Except FHLB/FHLMC	N/A	459,925	428,595	441,945
Other Investments	7,363,969	8,936,497	8,153,274	9,125,692
Accrued Interest Receivable	183,135	164,109	159,354	209,393
Valuation Allowances	(8,327)	(16,391)	(28,923)	(96,490)
Net Cash & Investment Sec.	12,331,684	13,565,743	13,888,965	16,157,980
Net Fixed Assets	966,183	1,177,634	1,413,981	1,635,650
Investment in Ser. Corps./Subs.	2,496,400	3,991,572	5,065,874	6,104,854
Deferred Net Losses (Gains)	196,417	233,296	254,156	169,096
Intangible Assets	3,991,759	4,556,686	4,684,033	6,345,535
Other Assets	2,101,680	2,549,116	2,971,021	3,382,319
TOTAL ASSETS	$ 75,137,288	$ 87,080,886	$ 98,726,796	$ 115,404,585

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GAAP SOL. FSLIC THRIFTS-IEA/IBL<90%
BALANCE SHEETS
(Dollars in Thousands)

LIABILITIES	1984	1985	1986	1987
Fixed-Maturity Deposits	$ 42,671,291	$ 48,226,417	$ 53,817,536	$ 64,394,556
Transaction Accounts	2,662,639	3,352,754	4,511,155	5,157,348
Money Market Deposit Accounts	8,546,938	10,173,079	10,987,304	9,554,724
Passbook Accounts	3,648,444	3,627,569	4,527,455	5,717,956
Total Savings Deposits	57,529,312	65,379,819	73,843,450	84,824,584
FHLB Advances	6,086,682	7,635,413	8,747,400	10,314,985
Repurchase Agreements	3,830,232	4,149,793	3,843,145	7,505,863
Commercial Paper Issued	5	0	0	0
Sub.Deb. not Qual. as Reg.Cap.	79,261	139,502	6,570	7,325
Mortgage-Backed Bonds Issued	1,583,150	1,693,850	2,987,141	2,658,702
Other Borrowings	1,641,563	2,080,363	2,595,326	3,412,898
Other Liabilities	1,688,718	2,306,016	2,224,725	2,229,185
TOTAL LIABILITIES	72,438,946	83,384,781	94,247,789	110,953,579
REGULATORY CAPITAL				
Preferred Stock	35,345	13,971	21,095	255,307
Permanent Stock	151,348	120,475	167,106	187,435
Contributed Capital	879,898	1,244,908	1,917,353	1,940,566
Qualifying Mutual Cap. Cert.	3,106	3,106	4,356	5,943
Qualifying Subordinated Deb.	28,552	152,835	333,875	414,000
Appraised Equity Capital	43,809	99,280	142,945	124,665
Net Worth & Income Cap. Cert.	157,500	206,475	159,125	136,888
Retained Earnings (Deficit)	1,398,784	1,855,048	1,733,144	1,386,204
TOTAL REGULATORY CAPITAL	2,698,342	3,696,104	4,479,007	4,451,009
TOTAL LIAB. & REG. CAPITAL	$ 75,137,288	$ 87,080,885	$ 98,726,795	$ 115,404,585

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GAAP SOL. FSLIC THRIFTS-IEA/IBL<90%
STATEMENTS OF OPERATIONS
(Dollars in Thousands)

	1984	1985	1986	1987
Interest Income	$ 6,191,786	$ 7,620,404	$ 7,798,296	$ 8,154,339
Interest Expense	5,789,127	6,977,531	7,156,434	7,269,009
Net Interest Inc. (Exp.)	402,659	642,873	641,862	885,330
Other Operating Income:				
Mortgage Loan Fees	263,816	318,367	316,837	271,748
Loan Servicing Fees	63,033	94,772	132,016	178,282
Other Loan Fees & Charges	60,410	69,734	98,297	92,130
Ser.Chgs. & Fees - Trans.Accts.	45,849	71,518	91,610	103,618
Service Corps./Subsidiaries	149,728	312,864	469,762	415,698
Other	184,203	180,138	239,276	143,712
Total Oth. Operating Income	767,039	1,047,393	1,347,798	1,205,188
Operating Expense:				
Officers & Employees Comp.	475,412	606,820	735,888	828,490
Legal Expense	19,768	32,792	49,378	64,448
Office Occ. & Equip. Expense	251,327	316,363	369,810	397,412
Marketing Expense	59,142	72,427	74,994	79,269
Professional Services	30,571	37,204	46,312	56,100
Amortization of Goodwill	127,957	193,612	202,322	223,860
Other	304,188	527,903	712,757	729,107
Total Operating Expense	1,268,365	1,787,121	2,191,461	2,378,686
NET OPER. INCOME (DEFICIT)	(98,667)	(96,855)	(201,801)	(288,168)
Non-Operating Income:				
Profit on Sale of REO & Other	136,684	108,278	100,421	124,193
Profit on Sale of Investments	111,297	346,942	419,355	322,600
Profit on Sale of Loans	212,300	536,295	623,237	255,283
Amortized Deferred Gains	3,297	1,761	4,772	3,287
Other	167,628	162,989	113,388	199,389
Total Non-Operating Income	631,206	1,156,265	1,261,173	904,752
Non-Operating Expense:				
Provision for Losses on Assets	N/A	N/A	N/A	729,538
Loss on Sale of REO & Other	73,733	123,414	242,915	65,631
Loss on Sale of Investments	46,789	34,638	77,342	79,583
Loss on Sale of Loans	157,599	221,693	552,836	71,278
Amortized Deferred Losses	3,336	8,698	10,822	9,614
Other	49,355	46,243	87,513	106,233
Total Non-Operating Expense	330,812	434,686	971,428	1,061,877
INCOME (LOSS) BEF. TAXES & ADJ.	201,727	624,724	87,944	(445,293)
Income Taxes (Credits)	31,149	63,415	(37,614)	(71,181)
NET INCOME (LOSS) BEFORE ADJ.	170,534	561,239	125,488	(374,189)
Prior Period Adjustments	(28,682)	(20,618)	(20,782)	(3,897)
ADJUSTED NET INCOME (LOSS)	$ 141,853	$ 540,620	$ 104,706	$ (378,085)

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GAAP SOL. FSLIC THRIFTS-IEA/IBL<90%
FINANCIAL RATIOS - BALANCE SHEETS
(As a Percent of Total Assets)

ASSETS	1984	1985	1986	1987
Construction Loans On:				
1-4 Dwelling Units	N/A	N/A	N/A	1.43
5 or More Dwelling Units	N/A	N/A	N/A	1.28
Nonresidential	N/A	N/A	N/A	1.93
Permanent Mortgages On:				
1-4 Dwelling Units	35.09	28.78	26.26	23.60
5 or More Dwelling Units	7.10	7.90	7.57	5.53
Nonresidential (Except Land)	8.74	9.92	9.51	6.41
Dev. Bldg. Lots, Land, Etc.	4.71	7.74	8.49	6.88
Mortgage Backed Securities	9.88	9.46	9.86	14.82
Accrued Interest Receivable	0.85	0.92	0.94	0.93
Other Mortgage Receivables	2.18	1.81	2.17	0.51
Loans in Process	(3.84)	(4.17)	(3.45)	(2.44)
Unearned Disc. & Def. Loan Fees	(2.54)	(2.01)	(1.41)	(1.14)
Specific Reserves & Val. Allow.	(0.36)	(0.37)	(0.59)	(0.86)
Net Mortgage Loans	61.82	59.98	59.35	58.87
Commercial Loans	2.07	2.68	3.53	2.71
Consumer Loans	4.47	4.77	4.64	4.93
Financing Leases	0.10	0.12	0.11	0.10
Accrued Interest Receivable	0.12	0.10	0.12	0.11
Loans in Process	(0.07)	(0.23)	(0.11)	(0.05)
Unearned Disc. & Def. Loan Fees	(0.16)	(0.16)	(0.13)	(0.08)
Specific Reserves & Val. Allow.	(0.05)	(0.06)	(0.11)	(0.12)
Net Nonmortgage Loans	6.48	7.20	8.06	7.60
Repossessed Assets	0.69	1.11	1.95	2.87
Valuation Allowances	(0.06)	(0.14)	(0.22)	(0.39)
Net Repossessed Assets	0.63	0.97	1.73	2.49
Real Estate Held For Dev., Etc.	1.70	1.93	2.27	1.93
Valuation Allowances	(0.03)	(0.03)	(0.05)	(0.17)
Net Real Estate Held for Dev.	1.67	1.90	2.22	1.76
Cash & Demand Deposits	1.76	1.66	1.64	1.53
U.S. Govt. & Agency Securities	4.62	2.96	3.60	4.08
Equity Sec., Except FHLB/FHLMC	N/A	0.53	0.43	0.38
Other Investments	9.80	10.26	8.26	7.91
Accrued Interest Receivable	0.24	0.19	0.16	0.18
Valuation Allowances	(0.01)	(0.02)	(0.03)	(0.08)
Net Cash & Investment Sec.	16.41	15.58	14.07	14.00
Net Fixed Assets	1.29	1.35	1.43	1.42
Investment in Ser. Corps./Subs.	3.32	4.58	5.13	5.29
Deferred Net Losses (Gains)	0.26	0.27	0.26	0.15
Intangible Assets	5.31	5.23	4.74	5.50
Other	2.80	2.93	3.01	2.93
TOTAL ASSETS	100.00	100.00	100.00	100.00

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GAAP SOL. FSLIC THRIFTS-IEA/IBL<90%
FINANCIAL RATIOS - BALANCE SHEETS
(As a Percent of Total Assets)

LIABILITIES	1984	1985	1986	1987
Fixed-Maturity Deposits	56.79	55.38	54.51	55.80
Transaction Accounts	3.54	3.85	4.57	4.47
Money Market Deposit Accounts	11.38	11.68	11.13	8.28
Passbook Accounts	4.86	4.17	4.59	4.95
Total Savings Deposits	76.57	75.08	74.80	73.50
FHLB Advances	8.10	8.77	8.86	8.94
Repurchase Agreements	5.10	4.77	3.89	6.50
Commercial Paper Issued	0.00	0.00	0.00	0.00
Sub. Deb. not Qual. as Reg. Cap.	0.11	0.16	0.01	0.01
Mortgage-Backed Bonds Issued	2.11	1.95	3.03	2.30
Other Borrowings	2.18	2.39	2.63	2.96
Other Liabilities	2.25	2.65	2.25	1.93
TOTAL LIABILITIES	96.41	95.76	95.46	96.14
REGULATORY CAPITAL				
Preferred Stock	0.05	0.02	0.02	0.22
Permanent Stock	0.20	0.14	0.17	0.16
Contributed Capital	1.17	1.43	1.94	1.68
Qualifying Mutual Cap. Cert.	0.00	0.00	0.00	0.01
Qualifying Subordinated Deb.	0.04	0.18	0.34	0.36
Appraised Equity Capital	0.06	0.11	0.14	0.11
Net Worth & Income Cap. Cert.	0.21	0.24	0.16	0.12
Retained Earnings (Deficit)	1.86	2.13	1.76	1.20
TOTAL REGULATORY CAPITAL	3.59	4.24	4.54	3.86
TOTAL LIABILITIES & REG. CAP.	100.00	100.00	100.00	100.00

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GAAP SOL. FSLIC THRIFTS-IEA/IBL<90%
FINANCIAL RATIOS - STATEMENTS OF OPERATIONS
(As a Percent of Average Assets)

	1984	1985	1986	1987
Interest Income	9.72	9.40	8.39	7.62
Interest Expense	9.09	8.60	7.70	6.79
Net Interest Inc. (Exp.)	0.63	0.79	0.69	0.83
Other Operating Income:				
Mortgage Loan Fees	0.41	0.39	0.34	0.25
Loan Servicing Fees	0.10	0.12	0.14	0.17
Other Loan Fees & Charges	0.09	0.09	0.11	0.09
Ser.Chgs. & Fees-Trans.Accts	0.07	0.09	0.10	0.10
Service Corps./Subsidiaries	0.24	0.39	0.51	0.39
Other	0.29	0.22	0.26	0.13
Total Oth. Operating Income	1.20	1.29	1.45	1.13
Operating Expense:				
Officers & Employees Comp.	0.75	0.75	0.79	0.77
Legal Expense	0.03	0.04	0.05	0.06
Office Occ. & Equip. Expense	0.39	0.39	0.40	0.37
Marketing Expense	0.09	0.09	0.08	0.07
Professional Services	0.05	0.05	0.05	0.05
Amortization of Goodwill	0.20	0.24	0.22	0.21
Other	0.48	0.65	0.77	0.68
Total Operating Expense	1.99	2.20	2.36	2.22
NET OPER. INCOME (DEFICIT)	(0.15)	(0.12)	(0.22)	(0.27)
Non-Operating Income:				
Profit on Sale of REO & Other	0.21	0.13	0.11	0.12
Profit on Sale of Investments	0.17	0.43	0.45	0.30
Profit on Sale of Loans	0.33	0.66	0.67	0.24
Amortized Deferred Gains	0.01	0.00	0.01	0.00
Other	0.26	0.20	0.12	0.19
Total Non-Operating Income	0.99	1.43	1.36	0.85
Non-Operating Expense:				
Provision for Losses on Assets	N/A	N/A	N/A	0.68
Loss on Sale of REO & Other	0.12	0.15	0.26	0.06
Loss on Sale of Investments	0.07	0.04	0.08	0.07
Loss on Sale of Loans	0.25	0.27	0.60	0.07
Amortized Deferred Losses	0.01	0.01	0.01	0.01
Other	0.08	0.06	0.09	0.10
Total Non-Operating Expense	0.52	0.54	1.05	0.99
INCOME (LOSS) BEF. TAXES & ADJ.	0.32	0.77	0.09	(0.42)
Income Taxes (Credits)	0.05	0.08	(0.04)	(0.07)
NET INCOME (LOSS) BEFORE ADJ.	0.27	0.69	0.14	(0.35)
Prior Period Adjustments	(0.05)	(0.03)	(0.02)	(0.00)
ADJUSTED NET INCOME (LOSS)	0.22	0.67	0.11	(0.35)

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GAAP SOL. FSLIC THRIFTS-IEA/IBL<90%
QUARTERLY STATEMENTS OF OPERATIONS
(Dollars in Thousands)

	3/31/87	6/30/87	9/30/87	12/31/87
Interest Income	$ 1,888,054	$ 2,016,119	$ 2,029,287	$ 2,220,879
Interest Expense	1,676,188	1,723,558	1,833,635	2,035,628
Net Interest Inc. (Exp.)	211,866	292,561	195,652	185,251
Other Operating Income:				
Mortgage Loan Fees	62,569	80,153	65,799	63,227
Loan Servicing Fees	36,457	47,759	44,042	50,024
Other Loan Fees & Charges	21,618	22,391	25,512	22,609
Ser.Chgs. & Fees-Trans.Accts	24,331	24,790	25,981	28,516
Service Corps./Subsidiaries	134,669	162,026	90,646	28,357
Other	48,094	19,060	33,203	43,355
Total Oth. Operating Income	327,738	356,179	285,183	236,088
Operating Expense:				
Officers & Employees Comp.	200,157	204,036	204,615	219,682
Legal Expense	12,283	16,003	16,187	19,975
Office Occ. & Equip. Expense	94,403	97,050	99,342	106,617
Marketing Expense	16,704	20,904	17,656	24,005
Professional Services	12,353	12,817	14,299	16,631
Amortization of Goodwill	51,046	54,295	56,886	61,633
Other	181,458	193,331	169,080	185,238
Total Operating Expense	568,404	598,436	578,065	633,781
NET OPER. INCOME (DEFICIT)	(28,800)	50,304	(97,230)	(212,442)
Non-Operating Income:				
Profit on Sale of REO & Other	27,526	25,595	19,961	51,111
Profit on Sale of Investments	95,956	78,374	63,329	84,941
Profit on Sale of Loans	105,988	83,648	25,552	40,095
Amortized Deferred Gains	359	2,640	160	128
Other	14,695	35,137	76,824	72,733
Total Non-Operating Income	244,524	225,394	185,826	249,008
Non-Operating Expense:				
Provision for Losses on Assets	130,421	170,426	129,416	299,275
Loss on Sale of REO & Other	10,930	14,024	17,304	23,373
Loss on Sale of Investments	13,415	34,524	21,318	10,326
Loss on Sale of Loans	19,689	24,384	15,415	11,790
Amortized Deferred Losses	2,423	2,248	2,791	2,152
Other	7,456	65,570	17,731	15,476
Total Non-Operating Expense	184,334	311,176	203,975	362,392
INCOME (LOSS) BEF. TAXES & ADJ.	31,390	(35,478)	(115,379)	(325,826)
Income Taxes (Credits)	(19,025)	(17,990)	(16,739)	(17,427)
NET INCOME (LOSS) BEFORE ADJ.	50,398	(17,508)	(98,665)	(308,414)
Prior Period Adjustments	(83)	(2,157)	(1,258)	(399)
ADJUSTED NET INCOME (LOSS)	$ 50,314	$ (19,663)	$ (99,923)	$ (308,813)

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GAAP SOL. FSLIC THRIFTS-IEA/IBL<90%

FINANCIAL RATIOS - QUARTERLY STATEMENTS OF OPERATIONS
(As a Percent of Average Assets)

	3/31/87	6/30/87	9/30/87	12/31/87
Interest Income	7.05	7.53	7.58	8.30
Interest Expense	6.26	6.44	6.85	7.61
Net Interest Inc. (Exp.)	0.79	1.09	0.73	0.69
Other Operating Income:				
Mortgage Loan Fees	0.23	0.30	0.25	0.24
Loan Servicing Fees	0.14	0.18	0.16	0.19
Other Loan Fees & Charges	0.08	0.08	0.10	0.08
Ser.Chgs. & Fees-Trans.Accts	0.09	0.09	0.10	0.11
Service Corps./Subsidiaries	0.50	0.61	0.34	0.11
Other	0.18	0.07	0.12	0.16
Total Other Oper. Income	1.22	1.33	1.07	0.88
Operating Expense:				
Officers & Employees Comp.	0.75	0.76	0.76	0.82
Legal Expense	0.05	0.06	0.06	0.07
Office Occ. & Equip. Expense	0.35	0.36	0.37	0.40
Marketing Expense	0.06	0.08	0.07	0.09
Professional Services	0.05	0.05	0.05	0.06
Amortization of Goodwill	0.19	0.20	0.21	0.23
Other	0.68	0.72	0.63	0.69
Total Operating Expense	2.12	2.24	2.16	2.37
NET OPER. INCOME (DEFICIT)	(0.11)	0.19	(0.36)	(0.79)
Non-Operating Income:				
Profit on Sale of REO & Other	0.10	0.10	0.07	0.19
Profit on Sale of Investments	0.36	0.29	0.24	0.32
Profit on Sale of Loans	0.40	0.31	0.10	0.15
Amortized Deferred Gains	0.00	0.01	0.00	0.00
Other	0.05	0.13	0.29	0.27
Total Non-Operating Income	0.91	0.84	0.69	0.93
Non-Operating Expense:				
Provision for Losses on Assets	0.49	0.64	0.48	1.12
Loss on Sale of REO & Other	0.04	0.05	0.06	0.09
Loss on Sale of Investments	0.05	0.13	0.08	0.04
Loss on Sale of Loans	0.07	0.09	0.06	0.04
Amortized Deferred Losses	0.01	0.01	0.01	0.01
Other	0.03	0.24	0.07	0.06
Total Non-Operating Expense	0.69	1.16	0.76	1.35
INCOME (LOSS) BEF. TAXES & ADJ.	0.12	(0.13)	(0.43)	(1.22)
Income Taxes (Credits)	(0.07)	(0.07)	(0.06)	(0.07)
NET INCOME (LOSS) BEFORE ADJ.	0.19	(0.07)	(0.37)	(1.15)
Prior Period Adjustments	(0.00)	(0.01)	(0.00)	(0.00)
ADJUSTED NET INCOME (LOSS)	0.19	(0.07)	(0.37)	(1.15)

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GAAP SOL. FSLIC THRIFTS-IEA/IBL<90%
HISTORICAL & FORECASTED BALANCE SHEETS
(Dollars in Thousands)

Page 1

	HISTORICAL			FORECASTED			
	1984	1985	1986	1987	1988	1989	1990
ASSETS							
Earning Assets	$ 61,717,516	$ 69,948,307	$ 78,302,962	$ 90,900,310	$ 90,900,310	$ 90,900,310	$ 90,900,310
Non-Earning Assets	13,419,772	17,132,579	20,423,834	24,504,275	24,504,275	24,504,275	24,504,275
TOTAL ASSETS	$ 75,137,288	$ 87,080,886	$ 98,726,796	$ 115,404,585	$ 115,404,585	$ 115,404,585	$ 115,404,585
LIABILITIES							
Interest Bearing Liab.	$ 70,750,226	$ 81,078,770	$ 92,023,060	$ 108,886,787	$ 109,500,417	$ 110,160,686	$ 110,871,139
Non-Interest Bearing Liab.	1,688,720	2,306,011	2,224,729	2,229,184	2,229,184	2,229,184	2,229,184
TOTAL LIABILITIES	72,438,946	83,384,781	94,247,789	111,115,971	111,729,601	112,389,870	113,100,323
REGULATORY CAPITAL							
Preferred Stock	35,345	13,971	21,095	255,307	255,307	255,307	255,307
Perm. Stock & Cont. Cap.	1,031,246	1,365,383	2,084,459	2,128,001	2,128,001	2,128,001	2,128,001
Qualif. Subordinated Deb.	31,658	155,941	338,231	414,000	414,000	414,000	414,000
Appraised Equity Capital	43,809	99,280	142,965	124,665	124,665	124,665	124,665
Net Worth & Income Cap. Cert.	157,500	206,475	159,125	136,888	136,888	136,888	136,888
Retained Earnings (Deficit)	1,398,784	1,855,048	1,733,144	1,318,996	705,366	45,097	(665,356)
Dividends Paid	(48,521)	(73,193)	(49,481)	(89,243)	(89,243)	(89,243)	(89,243)
TOTAL REGULATORY CAPITAL	2,698,342	3,696,104	4,479,007	4,288,614	3,674,984	3,014,715	2,304,262
TOTAL LIABS. & REG. CAP.	$ 75,137,288	$ 87,080,885	$ 98,726,795	$ 115,404,585	$ 115,404,585	$ 115,404,585	$ 115,404,585

HISTORICAL & FORECASTED SELECTED FINANCIAL HIGHLIGHTS

	HISTORICAL			FORECASTED			
	1984	1985	1986	1987	1988	1989	1990
Average Assets	$ 63,685,029	$ 81,109,087	$ 92,903,841	$ 107,065,691	$ 115,404,585	$ 115,404,585	$ 115,404,585
% Change in Assets	43.85	15.90	13.37	16.89	0.00	0.00	0.00
Reg. Capital/Total Assets	3.59	4.24	4.54	3.72	3.18	2.61	2.00
Return on Average Assets	0.22	0.67	0.11	(0.42)	(0.45)	(0.49)	(0.56)
Return on Average Reg. Cap.	6.08	16.91	2.56	(10.16)	(13.17)	(17.07)	(23.36)
Yield on Earning Assets	11.90	11.58	10.48	9.64	9.64	9.64	9.64
Cost of Funds	9.98	9.26	8.35	7.24	7.32	7.32	7.32
Yield/Cost Spread	1.92	2.32	2.13	2.40	2.32	2.32	2.32
Int.Earn.Asst./Int.Bear.Liab.	87.23	86.27	85.09	83.48	83.01	82.52	81.99

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GAAP SOL. FSLIC THRIFTS-IEA/IBL<90%
HISTORICAL & FORECASTED STATEMENTS OF OPERATIONS
(Dollars in Thousands)

	HISTORICAL			FORECASTED			
	1984	1985	1986	1987	1988	1989	1990
Interest Income	$ 6,191,786	$ 7,620,404	$ 7,798,296	$ 8,154,339	$ 8,760,517	$ 8,760,517	$ 8,760,517
Interest Expense	5,789,127	6,977,531	7,156,434	7,269,009	7,995,374	8,042,013	8,092,196
Net Interest Inc. (Exp.)	402,659	642,873	641,862	885,330	765,143	718,505	668,321
Other Operating Income:							
Mortgage Loan Fees	263,816	318,367	316,837	271,748	292,897	292,897	292,897
Loan Servicing Fees	63,033	94,772	132,016	178,282	192,149	192,149	192,149
Other Loan Fees & Charges	60,410	69,734	98,297	92,130	99,248	99,248	99,248
Ser.Chg. & Fees-Trans Accts.	45,849	71,518	91,610	103,618	111,712	111,712	111,712
Service Corps./Subsidiaries	149,728	312,864	469,762	415,698	415,698	415,698	415,698
Other	184,203	180,138	239,276	143,712	154,873	154,873	154,873
Total Oth. Operating Inc.	767,039	1,047,393	1,347,798	1,205,188	1,266,576	1,266,576	1,266,576
Operating Expense:							
Officers & Employees Comp.	475,412	606,820	735,888	828,490	893,001	893,001	893,001
Legal Expense	19,768	32,792	49,378	64,448	69,474	69,474	69,474
Office Occ. & Equip. Exp.	251,327	316,363	369,810	397,412	428,382	428,382	428,382
Marketing Expense	59,142	72,427	74,994	79,269	85,399	85,399	85,399
Professional Services	30,571	37,204	46,312	56,100	60,472	60,472	60,472
Amortization of Goodwill	127,957	193,612	202,322	223,860	223,860	223,860	223,860
Other	304,188	527,903	712,757	729,107	785,905	785,905	785,905
Total Operating Expense	1,268,365	1,787,121	2,191,461	2,378,686	2,546,493	2,546,493	2,546,493
NET OPER. INC. (DEFICIT)	(98,667)	(96,855)	(201,801)	(288,168)	(514,773)	(561,412)	(611,595)
Non-Operating Income:							
Profit on Sales of REO & Oth	136,684	108,278	100,421	124,193	0	0	0
Profit on Sale of Investments	111,297	346,942	419,355	322,600	0	0	0
Profit on Sale of Loans	212,300	536,295	623,237	255,283	0	0	0
Amortized Deferred Gains	3,297	1,761	4,772	3,287	0	0	0
Other	167,628	162,989	113,388	199,389	0	0	0
Total Non-Operating Inc.	631,206	1,156,265	1,261,173	904,752	0	0	0
Non-Operating Expense:							
Prov. for Losses on Assets	N/A	N/A	N/A	729,538	0	0	0
Loss on Sale of REO & Other	73,733	123,414	242,915	65,631	0	0	0
Loss on Sale of Investments	46,789	34,638	77,342	79,583	0	0	0
Loss on Sale of Loans	157,599	221,693	552,836	71,278	0	0	0
Amortized Deferred Losses	3,336	8,698	10,822	9,614	9,614	9,614	9,614
Other	49,355	46,243	87,513	106,233	0	0	0
Total Non-Operating Exp.	330,812	434,686	971,428	1,061,877	9,614	9,614	9,614
INC.(LOSS) BEF. TAXES & ADJ.	201,727	624,724	87,944	(445,293)	(524,387)	(571,026)	(621,209)
Income Taxes (Credits)	31,149	63,415	(37,614)	0	0	0	0
NET INCOME (LOSS) BEF. ADJ.	170,534	561,239	125,488	(445,293)	(524,387)	(571,026)	(621,209)
Prior Period Adjustments	(28,682)	(20,618)	(20,782)	0	0	0	0
ADJUSTED NET INCOME (LOSS)	$ 141,853	$ 540,620	$ 104,706	$ (445,293)	$ (524,387)	$ (571,026)	$ (621,209)

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GAAP SOL. FSLIC THRIFTS-IEA/IBL<90%
HISTORICAL & FORECASTED FINANCIAL RATIOS - BALANCE SHEETS
(As a Percent of Total Assets)

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	HISTORICAL			FORECASTED			
	1984	1985	1986	1987	1988	1989	1990
ASSETS							
Earning Assets	82.14	80.33	79.31	78.77	78.77	78.77	78.77
Non-Earning Assets	17.86	19.67	20.69	21.23	21.23	21.23	21.23
TOTAL ASSETS	100.00	100.00	100.00	100.00	100.00	100.00	100.00
LIABILITIES							
Interest Bearing Liab.	94.16	93.11	93.21	94.35	94.88	95.46	96.07
Non-Interest Bearing Liab.	2.25	2.65	2.25	1.93	1.93	1.93	1.93
TOTAL LIABILITIES	96.41	95.76	95.46	96.28	96.82	97.39	98.00
REGULATORY CAPITAL							
Preferred Stock	0.05	0.02	0.02	0.22	0.22	0.22	0.22
Perm. Stock & Cont. Cap.	1.37	1.57	2.11	1.84	1.84	1.84	1.84
Qualif. Subordinated Deb.	0.04	0.18	0.34	0.36	0.36	0.36	0.36
Appraised Equity Capital	0.06	0.11	0.14	0.11	0.11	0.11	0.11
Net Worth & Income Cap. Cert.	0.21	0.24	0.16	0.12	0.12	0.12	0.12
Retained Earnings (Deficit)	1.86	2.13	1.76	1.14	0.61	0.04	(0.58)
Dividends Paid	(0.06)	(0.08)	(0.05)	(0.08)	(0.08)	(0.08)	(0.08)
TOTAL REGULATORY CAPITAL	3.59	4.24	4.54	3.72	3.18	2.61	2.00
TOTAL LIABS. & REG. CAP.	100.00	100.00	100.00	100.00	100.00	100.00	100.00

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GAAP SOL. FSLIC THRIFTS-IEA/IBL<90%
HISTORICAL & FORECASTED FINANCIAL RATIOS - STATEMENTS OF OPERATIONS
(As a Percent of Average Assets)

	HISTORICAL			FORECASTED			
	1984	1985	1986	1987	1988	1989	1990
Interest Income	9.72	9.40	8.39	7.62	7.59	7.59	7.59
Interest Expense	9.09	8.60	7.70	6.79	6.93	6.97	7.01
Net Interest Inc. (Exp.)	0.63	0.79	0.69	0.83	0.66	0.62	0.58
Other Operating Income:							
Mortgage Loan Fees	0.41	0.39	0.34	0.25	0.25	0.25	0.25
Loan Servicing Fees	0.10	0.12	0.14	0.17	0.17	0.17	0.17
Other Loan Fees & Charges	0.09	0.09	0.11	0.09	0.09	0.09	0.09
Ser.Chg. & Fees-Trans.Accts.	0.07	0.09	0.10	0.10	0.10	0.10	0.10
Service Corps./Subsidiaries	0.24	0.39	0.51	0.39	0.36	0.36	0.36
Other	0.29	0.22	0.26	0.13	0.13	0.13	0.13
Total Oth. Operating Inc.	1.20	1.29	1.45	1.13	1.10	1.10	1.10
Operating Expense:							
Officers & Employees Comp.	0.75	0.75	0.79	0.77	0.77	0.77	0.77
Legal Expense	0.03	0.04	0.05	0.06	0.06	0.06	0.06
Office Occ. & Equip. Exp.	0.39	0.39	0.40	0.37	0.37	0.37	0.37
Marketing Expense	0.09	0.09	0.08	0.07	0.07	0.07	0.07
Professional Services	0.05	0.05	0.05	0.05	0.05	0.05	0.05
Amortization of Goodwill	0.20	0.24	0.22	0.21	0.19	0.19	0.19
Other	0.48	0.65	0.77	0.68	0.68	0.68	0.68
Total Operating Expense	1.99	2.20	2.36	2.22	2.21	2.21	2.21
NET OPER. INC. (DEFICIT)	(0.15)	(0.12)	(0.22)	(0.27)	(0.45)	(0.49)	(0.53)
Non-Operating Income:							
Profit on Sales of REO & Oth	0.21	0.13	0.11	0.12	0.00	0.00	0.00
Profit on Sale of Investments	0.17	0.43	0.45	0.30	0.00	0.00	0.00
Profit on Sale of Loans	0.33	0.66	0.67	0.24	0.00	0.00	0.00
Amortized Deferred Gains	0.01	0.00	0.01	0.00	0.00	0.00	0.00
Other	0.26	0.20	0.12	0.19	0.00	0.00	0.00
Total Non-Operating Inc.	0.99	1.43	1.36	0.85	0.00	0.00	0.00
Non-Operating Expense:							
Prov. for Losses on Assets	N/A	N/A	N/A	0.68	0.00	0.00	0.00
Loss on Sale of REO & Other	0.12	0.15	0.26	0.06	0.00	0.00	0.00
Loss on Sale of Investments	0.07	0.04	0.08	0.07	0.00	0.00	0.00
Loss on Sale of Loans	0.25	0.27	0.60	0.07	0.00	0.00	0.00
Amortized Deferred Losses	0.01	0.01	0.01	0.01	0.01	0.01	0.01
Other	0.08	0.06	0.09	0.10	0.00	0.00	0.00
Total Non-Operating Exp.	0.52	0.54	1.05	0.99	0.01	0.01	0.01
INC.(LOSS) BEF. TAXES & ADJ.	0.32	0.77	0.09	(0.42)	(0.45)	(0.49)	(0.54)
Income Taxes (Credits)	0.05	0.08	(0.04)	0.00	0.00	0.00	0.00
NET INCOME (LOSS) BEFORE ADJ.	0.27	0.69	0.14	(0.42)	(0.45)	(0.49)	(0.54)
Prior Period Adjustments	(0.05)	(0.03)	(0.02)	0.00	0.00	0.00	0.00
ADJUSTED NET INCOME (LOSS)	0.22	0.67	0.11	(0.42)	(0.45)	(0.49)	(0.54)

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GAAP SOL. FSLIC THRIFTS-IEA/IBL<90%
FORECAST ASSUMPTIONS
(Dollars in Thousands)

		1987	1988	1989	1990
Total Annual Liability Growth		17.7254%	0.0000%	0.0000%	0.0000%
Chg. In Non-Earning Assets	$	0	0	0	0
Chg. In Preferred Stock Issues	$	0	0	0	0
Dividend Rate	F	0.0000%	0.0000%	0.0000%	0.0000%
Pay Yearly-1,Pass-2,Accrue-3		1	1	1	1
Repay. Preferred Stock Issues	$	0	0	0	0
Permanent Stock Infusions	$	0	0	0	0
New Subordinated Debt Issues	$	0	0	0	0
Repay. of Subordinated Debt	$	0	0	0	0
Accrual Rate - Each Issue	F	0.0000%	0.0000%	0.0000%	0.0000%
Appraised Equity Capital Adj.	$	0	0	0	0
N.W. & Inc. Capital Certifs.	$	0	0	0	0
Repay. NW. & Inc. Cap. Cert.	$	0	0	0	0
Interest Rate - Each Issue	F	0.0000%	0.0000%	0.0000%	0.0000%
Non-Cash Capital Infusion	$	0	0	0	0
Dividends Paid	$	0	89,243	89,243	89,243
Retained Earnings Adjustment	$	0	0	0	0
Yield on Exist. Earning Assets		9.6375%	9.6375%	9.6375%	9.6375%
Cost of Funds/Current Liabs.		7.3222%	7.3222%	7.3222%	7.3222%
SPREAD		2.3153%	2.3153%	2.3153%	2.3153%
Yield on New Earning Assets	F	9.5000%	9.6375%	9.6375%	9.6375%
Cost of Funds/New Liabilities		7.0000%	7.3222%	7.3222%	7.3222%
SPREAD		2.5000%	2.3153%	2.3153%	2.3153%
Mtg. Loan Fee/Avg. Assets		0.2538%	0.2538%	0.2538%	0.2538%
Mtg. Loans/Int.Earn.Assets		0.0000%	0.0000%	0.0000%	0.0000%
Yrs. Portfolio Amortization	#	8	8	8	N/A
Avg. Orig. Fee on New Loans		1.0000%	1.0000%	1.0000%	1.0000%
Loan Serv. Fees/Avg. Assets		0.1665%	0.1665%	0.1665%	0.1665%
Mtg. Loans Serv. for Others	$	50,671,333	50,671,333	50,671,333	50,671,333
Avg. Servicing Fee Income		0.0000%	0.0000%	0.0000%	0.0000%
Oth. Loan Fees/Avg. Assets		0.0860%	0.0860%	0.0860%	0.0860%
Fee Inc.-Trans.Ac./Avg. Assets		0.0968%	0.0968%	0.0968%	0.0968%
Trans. Ac./Int. Bear. Liabs.		4.7435%	4.7435%	4.7435%	4.7435%
Transaction Account Fees		0.0000%	0.0000%	0.0000%	0.0000%
Inc. (Loss) - Serv.Corps./Subs.	$	0	415,698	415,698	415,698
Other Operating Inc./Avg. Assets		0.1342%	0.1342%	0.1342%	0.1342%
Off. & Emp. Comp./Avg. Assets		0.7738%	0.7738%	0.7738%	0.7738%
Legal Expense/Avg. Assets		0.0602%	0.0602%	0.0602%	0.0602%
Office Occ.& Equip./Avg.Assets		0.3712%	0.3712%	0.3712%	0.3712%
Marketing Exp./Avg. Assets		0.0740%	0.0740%	0.0740%	0.0740%
Profess. Serv./Avg. Assets		0.0524%	0.0524%	0.0524%	0.0524%
Amortization of Goodwill	$	0	223,860	223,860	223,860
Oth. Oper. Exp./Avg. Assets		0.6810%	0.6810%	0.6810%	0.6810%
Profit on Sales of REO & Oth.	$	0	0	0	0
Profit on Sales of Investments	$	0	0	0	0
Profit on Sales of Loans	$	0	0	0	0
Amortized Deferred Gain	$	0	0	0	0
Other Non-Operating Income	$	0	0	0	0
Provision for Loss - Cash	$	0	0	0	0
Provision for Loss - Non-Cash	$	0	0	0	0
Loss on Sales of REO & Other	$	0	0	0	0
Loss on Sales of Investments	$	0	0	0	0
Loss on Sales of Loans	$	0	0	0	0
Amortized Deferred Loss	$	0	9,614	9,614	9,614
Other Non-Operating Expense	$	0	0	0	0
Income Tax %		0.0000%	0.0000%	0.0000%	0.0000%

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GAAP INSOLVENT FSLIC THRIFTS

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FINANCIAL HIGHLIGHTS
(Dollars in Thousands)

	1984	1985	1986	1987
Total Assets	$ 113,042,326	$ 131,814,436	$ 141,486,059	$ 142,914,552
% Change in Assets	22.19%	16.61%	7.34%	1.01%
Regulatory Capital	3,221,002	3,214,395	(2,686,452)	(14,836,140)
Estimated GAAP Capital	(35,550)	(976,311)	(7,177,533)	(19,099,418)
Tangible Capital	(2,586,473)	(3,881,996)	(10,244,410)	(22,389,968)
Regulatory Capital/Total Assets	2.85%	2.44%	(1.90%)	(10.38%)
Est. GAAP Capital/Total Assets	(0.03%)	(0.74%)	(5.07%)	(13.36%)
Tangible Capital/Total Assets	(2.29%)	(2.95%)	(7.24%)	(15.67%)
Net Income (Loss)	(49,964)	(769,387)	(5,809,615)	(10,049,216)
Return on Average Assets	(0.05%)	(0.63%)	(4.25%)	(7.07%)
Return on Avg. Regulatory Cap.	(1.66%)	(23.91%)	(200.85%)	
Yield on Loans	12.08%	11.59%	10.42%	8.87%
Yield on Investments	10.85%	9.96%	8.07%	7.57%
Yield on Earning Assets	11.93%	11.40%	10.16%	8.70%
Cost of Savings	9.98%	9.26%	8.18%	7.18%
Cost of Borrowings	11.83%	10.34%	9.58%	8.54%
Cost of Funds	10.20%	9.39%	8.37%	7.38%
Yield/Cost Spread	1.73%	2.01%	1.79%	1.32%
Amt.Elig. for Reg. Liquidity	11,296,779	10,636,891	13,299,606	11,815,492
Amt.Elig. for Reg.Liq./Tot.Assets	9.99%	8.07%	9.40%	8.27%
Int.Earn.Asst./Int.Bear.Liab.	88.71%	86.06%	81.15%	73.95%
Loans & Participations Purchased	8,846,378	9,969,877	9,919,472	7,553,303
Loans & Participations Sold	12,569,032	13,531,784	16,324,103	10,156,122
Mortg. Loans Serviced for Others	41,867,805	44,638,970	33,845,237	32,038,719
Mortg. Loans Serviced by Others	15,275,625	18,635,932	19,373,214	18,507,245
Broker Originated Deposits	3,678,575	4,754,111	5,733,944	8,762,626
Cash Div. on Preferred Stock	7,438	9,356	7,247	0
Cash Div. on Permanent Stock	121,519	35,065	16,349	343
Cash Div. on Other Cap. Inst.	581	498	164	16,725
Non 1-4 Con./Conv.Lns./Tot.Asst	26.46%	30.10%	28.36%	24.19%
Balloon & Adj. Rate Loans	27,072,901	39,289,347	40,156,593	38,837,541
Ser.Corp.Inc./Inv.in Ser.Corp.	7.56%	11.36%	(6.80%)	(12.61%)
OTHER INFORMATION				
Annual Closing Date	N/A	N/A	N/A	N/A
No. of Wholly-Owned Ser. Corps.	711	827	921	961
No. of Deposit Accounts	12,930,648	13,463,108	13,843,673	13,748,119

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GAAP INSOLVENT FSLIC THRIFTS
BALANCE SHEETS
(Dollars in Thousands)

ASSETS	1984	1985	1986	1987
Construction Loans On:				
1-4 Dwelling Units	$ N/A	$ N/A	$ N/A	$ 1,649,451
5 or More Dwelling Units	N/A	N/A	N/A	1,885,720
Nonresidential	N/A	N/A	N/A	3,809,564
Permanent Mortgages On:				
1-4 Dwelling Units	40,037,524	42,750,891	40,654,775	40,499,660
5 or More Dwelling Units	9,839,232	11,724,236	11,452,873	8,356,420
Nonresidential (Except Land)	13,525,833	17,954,791	18,511,116	13,536,856
Dev. Bldg. Lots, Land, Etc.	6,545,054	9,998,295	10,159,893	6,975,530
Mortgage Backed Securities	11,225,143	9,692,097	11,406,876	14,460,333
Accrued Interest Receivable	1,109,289	1,421,118	1,784,853	2,008,318
Other Mortgage Receivables	2,822,475	2,753,921	3,426,919	1,186,241
Loans in Process	(5,859,049)	(6,025,135)	(4,937,186)	(3,369,432)
Unearned Disc. & Def. Loan Fees	(1,387,346)	(1,090,463)	(947,528)	(827,088)
Specific Reserves & Val. Allow.	(327,189)	(978,590)	(2,676,169)	(4,911,779)
Net Mortgage Loans	77,530,969	88,201,159	88,836,408	85,259,790
Commercial Loans	1,478,187	2,676,695	3,303,090	3,637,104
Consumer Loans	5,283,947	6,959,718	7,356,788	7,345,426
Financing Leases	116,122	219,479	323,846	393,040
Accrued Interest Receivable	107,050	171,462	225,481	266,922
Loans in Process	(46,570)	(187,215)	(149,943)	(164,631)
Unearned Disc. & Def. Loan Fees	(184,819)	(170,997)	(105,817)	(84,235)
Specific Reserves & Val. Allow.	(66,127)	(198,478)	(487,453)	(935,161)
Net Nonmortgage Loans	6,687,813	9,470,681	10,465,994	10,458,456
Repossessed Assets	1,041,321	2,515,580	6,964,471	13,936,817
Valuation Allowances	(91,347)	(304,544)	(1,344,566)	(3,294,603)
Net Repossessed Assets	949,974	2,211,036	5,619,905	10,642,214
Real Estate Held For Dev., Etc.	686,121	1,605,749	2,469,967	3,161,127
Valuation Allowances	(3,419)	(117,850)	(352,737)	(542,148)
Net Real Estate Held for Dev.	682,702	1,487,899	2,117,230	2,618,979
Cash & Demand Deposits	1,875,443	1,964,963	2,381,325	2,126,141
U.S. Govt. & Agency Securities	4,605,218	3,739,321	4,206,542	5,103,814
Equity Sec., Except FHLB/FHLMC	N/A	81,004	52,510	54,207
Other Investments	7,716,977	7,668,426	10,354,661	10,447,612
Accrued Interest Receivable	175,148	145,911	168,553	196,902
Valuation Allowances	(13,367)	(14,534)	(21,229)	(29,880)
Net Cash & Investment Sec.	14,359,419	13,585,091	17,142,362	17,898,796
Net Fixed Assets	1,717,957	1,983,504	2,000,620	2,084,018
Investment in Ser. Corps./Subs.	3,033,601	5,305,070	5,107,182	4,443,941
Deferred Net Losses (Gains)	2,590,614	2,665,879	2,593,764	2,331,412
Intangible Assets	2,550,923	2,905,685	3,066,877	3,290,550
Other Assets	2,938,390	3,998,490	4,535,675	3,886,387
TOTAL ASSETS	$ 113,042,326	$ 131,814,436	$ 141,486,059	$ 142,914,552

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GAAP INSOLVENT FSLIC THRIFTS
BALANCE SHEETS
(Dollars in Thousands)

LIABILITIES	1984	1985	1986	1987
Fixed-Maturity Deposits	$ 72,081,423	$ 84,043,537	$ 91,303,295	$ 102,292,895
Transaction Accounts	3,951,474	4,831,665	6,379,778	6,698,447
Money Market Deposit Accounts	12,428,058	14,903,150	15,938,157	13,173,635
Passbook Accounts	6,262,104	6,363,209	7,701,172	8,300,826
Total Savings Deposits	94,723,059	110,141,561	121,322,402	130,465,803
FHLB Advances	8,345,199	11,103,727	14,871,957	16,732,514
Repurchase Agreements	3,153,952	2,825,000	2,917,247	4,700,705
Commercial Paper Issued	0	0	1,072	0
Sub.Deb. not Qual. as Reg.Cap.	39,235	4,276	26,285	37,021
Mortgage-Backed Bonds Issued	459,265	649,410	660,673	1,413,477
Other Borrowings	1,175,359	1,628,595	1,966,407	1,983,360
Other Liabilities	1,923,922	2,247,441	2,406,439	2,417,822
TOTAL LIABILITIES	109,821,328	128,600,042	144,172,508	157,750,695
REGULATORY CAPITAL				
Preferred Stock	96,017	100,670	102,473	94,667
Permanent Stock	132,159	148,112	158,388	152,483
Contributed Capital	483,584	689,829	644,180	716,341
Qualifying Mutual Cap. Cert.	0	0	692	0
Qualifying Subordinated Deb.	175,081	228,163	233,273	238,912
Appraised Equity Capital	399,824	420,679	520,817	498,704
Net Worth & Income Cap. Cert.	117,593	957,913	1,259,078	1,260,735
Retained Earnings (Deficit)	1,816,765	669,031	(5,605,354)	(17,797,973)
TOTAL REGULATORY CAPITAL	3,221,002	3,214,395	(2,686,452)	(14,836,140)
TOTAL LIAB. & REG. CAPITAL	$ 113,042,329	$ 131,814,435	$ 141,486,057	$ 142,914,554

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GAAP INSOLVENT FSLIC THRIFTS
STATEMENTS OF OPERATIONS
(Dollars in Thousands)

	1984	1985	1986	1987
Interest Income	$ 10,548,373	$ 11,560,931	$ 11,351,969	$ 10,045,872
Interest Expense	9,980,408	10,870,291	11,308,350	11,062,245
Net Interest Inc. (Exp.)	567,965	690,640	43,619	(1,016,373)
Other Operating Income:				
Mortgage Loan Fees	561,318	528,147	404,874	235,341
Loan Servicing Fees	78,123	128,024	136,487	107,790
Other Loan Fees & Charges	107,730	122,744	124,431	99,675
Ser.Chgs. & Fees - Trans.Accts.	64,071	98,233	120,807	134,977
Service Corps./Subsidiaries	167,012	473,547	(353,985)	(602,290)
Other	374,195	385,001	295,804	130,927
Total Oth. Operating Income	1,352,449	1,735,696	728,418	106,420
Operating Expense:				
Officers & Employees Comp.	800,922	985,642	1,132,019	1,161,429
Legal Expense	28,846	51,856	100,653	159,409
Office Occ. & Equip. Expense	405,533	508,166	601,756	668,460
Marketing Expense	105,034	103,678	103,502	98,302
Professional Services	53,431	71,869	127,347	137,888
Amortization of Goodwill	85,876	116,361	235,453	201,746
Other	501,592	865,214	1,124,065	1,097,455
Total Operating Expense	1,981,234	2,702,786	3,424,795	3,524,689
NET OPER. INCOME (DEFICIT)	(60,820)	(276,450)	(2,652,758)	(4,434,642)
Non-Operating Income:				
Profit on Sale of REO & Other	95,785	145,609	117,934	107,442
Profit on Sale of Investments	68,848	302,508	407,924	108,253
Profit on Sale of Loans	109,870	239,458	344,525	207,100
Amortized Deferred Gains	19,183	9,351	6,277	4,652
Other	157,249	248,730	240,251	279,545
Total Non-Operating Income	450,935	945,656	1,116,911	706,992
Non-Operating Expense:				
Provision for Losses on Assets	N/A	N/A	N/A	4,929,015
Loss on Sale of REO & Other	69,274	191,308	737,724	213,537
Loss on Sale of Investments	33,056	66,219	98,862	105,847
Loss on Sale of Loans	141,339	515,635	2,024,174	214,275
Amortized Deferred Losses	71,039	112,084	133,199	168,377
Other	67,596	139,993	357,730	589,788
Total Non-Operating Expense	382,304	1,025,239	3,351,689	6,220,839
INCOME (LOSS) BEF. TAXES & ADJ.	7,811	(356,033)	(4,887,536)	(9,948,489)
Income Taxes (Credits)	20,722	13,437	(95,754)	(34,406)
NET INCOME (LOSS) BEFORE ADJ.	(13,132)	(369,649)	(4,791,910)	(9,914,112)
Prior Period Adjustments	(36,832)	(399,742)	(1,017,716)	(135,097)
ADJUSTED NET INCOME (LOSS)	$ (49,964)	$ (769,387)	$ (5,809,615)	$ (10,049,216)

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GAAP INSOLVENT FSLIC THRIFTS
FINANCIAL RATIOS - BALANCE SHEETS
(As a Percent of Total Assets)

ASSETS	1984	1985	1986	1987
Construction Loans On:				
1-4 Dwelling Units	N/A	N/A	N/A	1.15
5 or More Dwelling Units	N/A	N/A	N/A	1.32
Nonresidential	N/A	N/A	N/A	2.67
Permanent Mortgages On:				
1-4 Dwelling Units	35.42	32.43	28.73	28.34
5 or More Dwelling Units	8.70	8.89	8.09	5.85
Nonresidential (Except Land)	11.97	13.62	13.08	9.47
Dev. Bldg. Lots, Land, Etc.	5.79	7.59	7.18	4.88
Mortgage Backed Securities	9.93	7.35	8.06	10.12
Accrued Interest Receivable	0.98	1.08	1.26	1.41
Other Mortgage Receivables	2.50	2.09	2.42	0.83
Loans in Process	(5.18)	(4.57)	(3.49)	(2.36)
Unearned Disc. & Def. Loan Fees	(1.23)	(0.83)	(0.67)	(0.58)
Specific Reserves & Val. Allow.	(0.29)	(0.74)	(1.89)	(3.44)
Net Mortgage Loans	68.59	66.91	62.79	59.66
Commercial Loans	1.31	2.03	2.33	2.54
Consumer Loans	4.67	5.28	5.20	5.14
Financing Leases	0.10	0.17	0.23	0.28
Accrued Interest Receivable	0.09	0.13	0.16	0.19
Loans in Process	(0.04)	(0.14)	(0.11)	(0.12)
Unearned Disc. & Def. Loan Fees	(0.16)	(0.13)	(0.07)	(0.06)
Specific Reserves & Val. Allow.	(0.06)	(0.15)	(0.34)	(0.65)
Net Nonmortgage Loans	5.92	7.18	7.40	7.32
Repossessed Assets	0.92	1.91	4.92	9.75
Valuation Allowances	(0.08)	(0.23)	(0.95)	(2.31)
Net Repossessed Assets	0.84	1.68	3.97	7.45
Real Estate Held For Dev., Etc.	0.61	1.22	1.75	2.21
Valuation Allowances	0.00	(0.09)	(0.25)	(0.38)
Net Real Estate Held for Dev.	0.60	1.13	1.50	1.83
Cash & Demand Deposits	1.66	1.49	1.68	1.49
U.S. Govt. & Agency Securities	4.07	2.84	2.97	3.57
Equity Sec., Except FHLB/FHLMC	N/A	0.06	0.04	0.04
Other Investments	6.83	5.82	7.32	7.31
Accrued Interest Receivable	0.15	0.11	0.12	0.14
Valuation Allowances	(0.01)	(0.01)	(0.02)	(0.02)
Net Cash & Investment Sec.	12.70	10.31	12.12	12.52
Net Fixed Assets	1.52	1.50	1.41	1.46
Investment in Ser. Corps./Subs.	2.68	4.02	3.61	3.11
Deferred Net Losses (Gains)	2.29	2.02	1.83	1.63
Intangible Assets	2.26	2.20	2.17	2.30
Other	2.60	3.03	3.21	2.72
TOTAL ASSETS	100.00	100.00	100.00	100.00

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GAAP INSOLVENT FSLIC THRIFTS
FINANCIAL RATIOS - BALANCE SHEETS
(As a Percent of Total Assets)

LIABILITIES	1984	1985	1986	1987
Fixed-Maturity Deposits	63.76	63.76	64.53	71.58
Transaction Accounts	3.50	3.67	4.51	4.69
Money Market Deposit Accounts	10.99	11.31	11.26	9.22
Passbook Accounts	5.54	4.83	5.44	5.81
Total Savings Deposits	83.79	83.56	85.75	91.29
FHLB Advances	7.38	8.42	10.51	11.71
Repurchase Agreements	2.79	2.14	2.06	3.29
Commercial Paper Issued	0.00	0.00	0.00	0.00
Sub. Deb. not Qual. as Reg. Cap.	0.03	0.00	0.02	0.03
Mortgage-Backed Bonds Issued	0.41	0.49	0.47	0.99
Other Borrowings	1.04	1.24	1.39	1.39
Other Liabilities	1.70	1.71	1.70	1.69
TOTAL LIABILITIES	97.15	97.56	101.90	110.38
REGULATORY CAPITAL				
Preferred Stock	0.08	0.08	0.07	0.07
Permanent Stock	0.12	0.11	0.11	0.11
Contributed Capital	0.43	0.52	0.46	0.50
Qualifying Mutual Cap. Cert.	0.00	0.00	0.00	0.00
Qualifying Subordinated Deb.	0.15	0.17	0.16	0.17
Appraised Equity Capital	0.35	0.32	0.37	0.35
Net Worth & Income Cap. Cert.	0.10	0.73	0.89	0.88
Retained Earnings (Deficit)	1.61	0.51	(3.96)	(12.45)
TOTAL REGULATORY CAPITAL	2.85	2.44	(1.90)	(10.38)
TOTAL LIABILITIES & REG. CAP.	100.00	100.00	100.00	100.00

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GAAP INSOLVENT FSLIC THRIFTS
FINANCIAL RATIOS - STATEMENTS OF OPERATIONS
(As a Percent of Average Assets)

	1984	1985	1986	1987
Interest Income	10.26	9.44	8.31	7.06
Interest Expense	9.71	8.88	8.28	7.78
Net Interest Inc. (Exp.)	0.55	0.56	0.03	(0.71)
Other Operating Income:				
Mortgage Loan Fees	0.55	0.43	0.30	0.17
Loan Servicing Fees	0.08	0.10	0.10	0.08
Other Loan Fees & Charges	0.10	0.10	0.09	0.07
Ser.Chgs. & Fees-Trans.Accts	0.06	0.08	0.09	0.09
Service Corps./Subsidiaries	0.16	0.39	(0.26)	(0.42)
Other	0.36	0.31	0.22	0.09
Total Oth. Operating Income	1.32	1.42	0.53	0.07
Operating Expense:				
Officers & Employees Comp.	0.78	0.81	0.83	0.82
Legal Expense	0.03	0.04	0.07	0.11
Office Occ. & Equip. Expense	0.39	0.42	0.44	0.47
Marketing Expense	0.10	0.08	0.08	0.07
Professional Services	0.05	0.06	0.09	0.10
Amortization of Goodwill	0.08	0.10	0.17	0.14
Other	0.49	0.71	0.82	0.77
Total Operating Expense	1.93	2.21	2.51	2.48
NET OPER. INCOME (DEFICIT)	(0.06)	(0.23)	(1.94)	(3.12)
Non-Operating Income:				
Profit on Sale of REO & Other	0.09	0.12	0.09	0.08
Profit on Sale of Investments	0.07	0.25	0.30	0.08
Profit on Sale of Loans	0.11	0.20	0.25	0.15
Amortized Deferred Gains	0.02	0.01	0.00	0.00
Other	0.15	0.20	0.18	0.20
Total Non-Operating Income	0.44	0.77	0.82	0.50
Non-Operating Expense:				
Provision for Losses on Assets	N/A	N/A	N/A	3.47
Loss on Sale of REO & Other	0.07	0.16	0.54	0.15
Loss on Sale of Investments	0.03	0.05	0.07	0.07
Loss on Sale of Loans	0.14	0.42	1.48	0.15
Amortized Deferred Losses	0.07	0.09	0.10	0.12
Other	0.07	0.11	0.26	0.41
Total Non-Operating Expense	0.37	0.84	2.45	4.37
INCOME (LOSS) BEF. TAXES & ADJ.	0.01	(0.29)	(3.58)	(7.00)
Income Taxes (Credits)	0.02	0.01	(0.07)	(0.02)
NET INCOME (LOSS) BEFORE ADJ.	(0.01)	(0.30)	(3.51)	(6.97)
Prior Period Adjustments	(0.04)	(0.33)	(0.74)	(0.10)
ADJUSTED NET INCOME (LOSS)	(0.05)	(0.63)	(4.25)	(7.07)

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GAAP INSOLVENT FSLIC THRIFTS
QUARTERLY STATEMENTS OF OPERATIONS
(Dollars in Thousands)

	3/31/87	6/30/87	9/30/87	12/31/87
Interest Income	$ 2,508,428	$ 2,488,358	$ 2,539,546	$ 2,509,540
Interest Expense	2,623,348	2,638,024	2,841,838	2,959,035
Net Interest Inc. (Exp.)	(114,920)	(149,666)	(302,292)	(449,495)
Other Operating Income:				
Mortgage Loan Fees	56,838	73,406	57,559	47,538
Loan Servicing Fees	27,115	27,222	27,231	26,222
Other Loan Fees & Charges	25,298	27,255	24,425	22,697
Ser.Chgs. & Fees-Trans.Accts	30,936	31,843	35,984	36,214
Service Corps./Subsidiaries	(96,210)	(66,390)	(106,964)	(332,726)
Other	54,663	37,683	32,938	5,643
Total Oth. Operating Income	98,640	131,019	71,173	(194,412)
Operating Expense:				
Officers & Employees Comp.	280,804	286,332	295,917	298,376
Legal Expense	29,695	38,020	44,726	46,968
Office Occ. & Equip. Expense	159,759	162,105	172,136	174,460
Marketing Expense	21,791	24,415	24,873	27,223
Professional Services	32,121	35,932	34,092	35,743
Amortization of Goodwill	38,610	39,848	37,656	85,632
Other	260,041	318,050	248,252	271,112
Total Operating Expense	822,821	904,702	857,652	939,514
NET OPER. INCOME (DEFICIT)	(839,101)	(923,349)	(1,088,771)	(1,583,421)
Non-Operating Income:				
Profit on Sale of REO & Other	16,850	30,381	28,096	32,115
Profit on Sale of Investments	54,660	33,422	10,926	9,245
Profit on Sale of Loans	108,100	45,517	28,759	24,724
Amortized Deferred Gains	1,214	1,119	1,087	1,232
Other	50,159	64,795	74,031	90,560
Total Non-Operating Income	230,983	175,234	142,899	157,876
Non-Operating Expense:				
Provision for Losses on Assets	742,676	1,479,493	1,098,454	1,608,392
Loss on Sale of REO & Other	41,225	61,844	43,880	66,588
Loss on Sale of Investments	28,579	45,159	17,746	14,363
Loss on Sale of Loans	38,582	41,708	43,398	90,587
Amortized Deferred Losses	33,871	33,432	60,421	40,653
Other	163,920	193,309	117,182	115,377
Total Non-Operating Expense	1,048,853	1,854,945	1,381,081	1,935,960
INCOME (LOSS) BEF. TAXES & ADJ.	(1,656,971)	(2,603,060)	(2,326,953)	(3,361,505)
Income Taxes (Credits)	(6,508)	3,274	(8,595)	(22,577)
NET INCOME (LOSS) BEFORE ADJ.	(1,650,457)	(2,606,350)	(2,318,382)	(3,338,923)
Prior Period Adjustments	(36,845)	(72,660)	(10,290)	(15,302)
ADJUSTED NET INCOME (LOSS)	$ (1,687,306)	$ (2,679,012)	$ (2,328,672)	$ (3,354,226)

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GAAP INSOLVENT FSLIC THRIFTS

FINANCIAL RATIOS - QUARTERLY STATEMENTS OF OPERATIONS
(As a Percent of Average Assets)

	3/31/87	6/30/87	9/30/87	12/31/87
Interest Income	7.06	7.00	7.14	7.06
Interest Expense	7.38	7.42	7.99	8.32
Net Interest Inc. (Exp.)	(0.32)	(0.42)	(0.85)	(1.26)
Other Operating Income:				
Mortgage Loan Fees	0.16	0.21	0.16	0.13
Loan Servicing Fees	0.08	0.08	0.08	0.07
Other Loan Fees & Charges	0.07	0.08	0.07	0.06
Ser.Chgs. & Fees-Trans.Accts	0.09	0.09	0.10	0.10
Service Corps./Subsidiaries	(0.27)	(0.19)	(0.30)	(0.94)
Other	0.15	0.11	0.09	0.02
Total Other Oper. Income	0.28	0.37	0.20	(0.55)
Operating Expense:				
Officers & Employees Comp.	0.79	0.81	0.83	0.84
Legal Expense	0.08	0.11	0.13	0.13
Office Occ. & Equip. Expense	0.45	0.46	0.48	0.49
Marketing Expense	0.06	0.07	0.07	0.08
Professional Services	0.09	0.10	0.10	0.10
Amortization of Goodwill	0.11	0.11	0.11	0.24
Other	0.73	0.89	0.70	0.76
Total Operating Expense	2.31	2.54	2.41	2.64
NET OPER. INCOME (DEFICIT)	(2.36)	(2.60)	(3.06)	(4.45)
Non-Operating Income:				
Profit on Sale of REO & Other	0.05	0.09	0.08	0.09
Profit on Sale of Investments	0.15	0.09	0.03	0.03
Profit on Sale of Loans	0.30	0.13	0.08	0.07
Amortized Deferred Gains	0.00	0.00	0.00	0.00
Other	0.14	0.18	0.21	0.25
Total Non-Operating Income	0.65	0.49	0.40	0.44
Non-Operating Expense:				
Provision for Losses on Assets	2.09	4.16	3.09	4.52
Loss on Sale of REO & Other	0.12	0.17	0.12	0.19
Loss on Sale of Investments	0.08	0.13	0.05	0.04
Loss on Sale of Loans	0.11	0.12	0.12	0.25
Amortized Deferred Losses	0.10	0.09	0.17	0.11
Other	0.46	0.54	0.33	0.32
Total Non-Operating Expense	2.95	5.22	3.88	5.45
INCOME (LOSS) BEF. TAXES & ADJ.	(4.66)	(7.32)	(6.55)	(9.46)
Income Taxes (Credits)	(0.02)	0.01	(0.02)	(0.06)
NET INCOME (LOSS) BEFORE ADJ.	(4.64)	(7.33)	(6.52)	(9.39)
Prior Period Adjustments	(0.10)	(0.20)	(0.03)	(0.04)
ADJUSTED NET INCOME (LOSS)	(4.75)	(7.54)	(6.55)	(9.44)

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GAAP INSOLVENT FSLIC THRIFTS
HISTORICAL & FORECASTED BALANCE SHEETS
(Dollars in Thousands)

Page 1

	HISTORICAL			FORECASTED			
	1984	1985	1986	1987	1988	1989	1990
ASSETS							
Earning Assets	$ 95,713,071	$ 108,734,128	$ 115,048,244	$ 114,956,047	$ 114,956,047	$ 114,956,047	$ 114,956,047
Non-Earning Assets	17,329,255	23,080,308	26,437,815	28,042,176	28,042,176	28,042,176	28,042,176
TOTAL ASSETS	$ 113,042,326	$ 131,814,436	$ 141,486,059	$ 142,998,223	$ 142,998,223	$ 142,998,223	$ 142,998,223
LIABILITIES							
Interest Bearing Liab.	$ 107,897,403	$ 126,352,585	$ 141,766,070	$ 155,332,863	$ 159,963,276	$ 164,948,641	$ 170,316,167
Non-Interest Bearing Liab.	1,923,925	2,247,457	2,406,438	2,417,832	2,417,832	2,417,832	2,417,832
TOTAL LIABILITIES	109,821,328	128,600,042	144,172,508	157,750,695	162,381,108	167,366,473	172,733,999
REGULATORY CAPITAL							
Preferred Stock	96,017	100,670	102,473	94,667	94,667	94,667	94,667
Perm. Stock & Cont. Cap.	615,743	837,941	802,568	868,824	868,824	868,824	868,824
Qualif. Subordinated Deb.	175,081	228,163	233,965	238,912	238,912	238,912	238,912
Appraised Equity Capital	399,824	420,679	520,817	498,704	498,704	498,704	498,704
Net Worth & Income Cap. Cert.	117,593	957,913	1,259,078	1,260,735	1,260,735	1,260,735	1,260,735
Retained Earnings (Deficit)	1,816,765	669,031	(5,605,354)	(17,697,246)	(22,344,727)	(27,330,092)	(32,697,618)
Dividends Paid	(129,538)	(44,919)	(23,760)	(17,068)	0	0	0
TOTAL REGULATORY CAPITAL	3,221,002	3,214,395	(2,686,452)	(14,752,472)	(19,382,885)	(24,368,250)	(29,735,776)
TOTAL LIABS. & REG. CAP.	$ 113,042,329	$ 131,814,435	$ 141,486,057	$ 142,998,223	$ 142,998,223	$ 142,998,223	$ 142,998,223

HISTORICAL & FORECASTED SELECTED FINANCIAL HIGHLIGHTS

	HISTORICAL			FORECASTED			
	1984	1985	1986	1987	1988	1989	1990
Average Assets	$ 102,779,273	$ 122,428,381	$ 136,650,248	$ 142,242,141	$ 142,998,223	$ 142,998,223	$ 142,998,223
% Change in Assets	22.19	16.61	7.34	1.07	0.00	0.00	0.00
Reg. Capital/Total Assets	2.85	2.44	(1.90)	(10.32)	(13.55)	(17.04)	(20.79)
Return on Average Assets	(0.05)	(0.63)	(4.25)	(6.99)	(3.26)	(3.49)	(3.75)
Return on Average Reg. Cap.	(1.66)	(23.91)	(200.85)				
Yield on Earning Assets	11.93	11.40	10.16	8.74	8.70	8.70	8.70
Cost of Funds	10.20	9.39	8.37	7.45	7.38	7.38	7.38
Yield/Cost Spread	1.73	2.01	1.79	1.29	1.32	1.32	1.32
Int.Earn.Asst./Int.Bear.Liab.	88.71	86.06	81.15	74.01	71.86	69.69	67.50

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GAAP INSOLVENT FSLIC THRIFTS
SELECTED FINANCIAL INFORMATION AT DECEMBER 31, 1987
(Dollars in Thousands)

Institution Name	Total Assets	Regulatory Capital	Reg. Cap./ Assets	Estimated GAAP Cap.	Est. GAAP Capital/ Assets	Tangible Capital	Tangible Capital/ Assets	Int.Earn. Asst/Int. Bear.Liab	Non 1-4 Con/Conv Lns/Assts	Net Repos Assets/ Tot Asst	Serv.Corp Inv./ Tot Asst	Net Oper. Income (Deficit)	Net Op. Inc (Def)/ Avg Asst	Adjusted Net Income (Loss)	Adj. Net Inc(Loss)/ Avg Asst
CT Totals, 1 Institution	153,017	(6,697)	(4.38)	(10,227)	(6.68)	(10,227)	(6.68)	91.25	11.16	0	(0.04)	(4,457)	(2.92)	(4,909)	(3.21)
MA Totals, 1 Institution	192,650	9,652	5.01	(154)	(0.08)	(154)	(0.08)	93.67	6.19	0.88	0.01	2,519	1.44	1,376	0.79
NJ Totals, 14 Institutions	3,635,702	(91,624)	(2.52)	(248,504)	(6.84)	(332,530)	(9.15)	85.93	9.33	1.42	1.00	(32,890)	(0.88)	(94,667)	(2.53)
NY Totals, 6 Institutions	2,385,096	78,600	3.30	(74,391)	(3.12)	(134,914)	(5.66)	89.49	19.12	0.53	1.56	22,987	0.96	(1,715)	(0.07)
PR Totals, 1 Institution	26,739	12	0.04	(53)	(0.20)	(53)	(0.20)	92.17	9.71	0.79	0	32	0.12	(182)	(0.68)
PA Totals, 5 Institutions	3,077,335	36,968	1.20	(40,731)	(1.32)	(215,785)	(7.01)	89.14	15.52	0.43	1.12	9,942	0.33	(5,967)	(0.20)
WV Totals, 2 Institutions	162,919	(12,244)	(7.52)	(15,301)	(9.39)	(15,901)	(9.76)	86.54	16.67	1.40	0.49	(502)	(0.29)	(3,821)	(2.24)
AL Totals, 5 Institutions	1,455,184	(30,948)	(2.13)	(71,183)	(4.89)	(92,620)	(6.36)	87.22	20.00	3.07	0.92	(2,900)	(0.21)	(34,011)	(2.43)
FL Totals, 21 Institutions	5,900,107	(612,279)	(10.38)	(667,791)	(11.32)	(691,265)	(11.72)	82.96	16.01	3.30	1.90	(116,145)	(2.26)	(268,484)	(5.23)
GA Totals, 9 Institutions	1,042,082	4,869	0.47	(21,709)	(2.08)	(25,597)	(2.46)	92.20	12.12	0.50	0.29	3,892	0.38	(1,552)	(0.15)
MD Totals, 7 Institutions	3,273,911	(53,644)	(1.64)	(194,475)	(5.94)	(218,433)	(6.67)	88.88	30.30	0.65	1.29	(50,856)	(1.56)	(117,638)	(3.62)
NC Totals, 5 Institutions	1,729,731	30,839	1.78	(45,828)	(2.65)	(89,789)	(5.19)	90.44	17.97	1.45	0.63	11,770	0.66	(5,771)	(0.32)
SC Totals, 3 Institutions	1,445,846	12,632	0.87	(33,095)	(2.29)	(33,095)	(2.29)	92.66	17.54	0.38	0.89	3,603	0.25	(5,468)	(0.37)
VA Totals, [illegible] Institutions	2,621,150	(16,870)	(0.64)	(83,111)	(3.17)	(87,136)	(3.32)	87.86	14.97	3.54	1.55	(35,762)	(1.39)	(51,200)	(2.00)
KY Totals, [illegible] Institutions	326,015	(53,058)	(16.27)	(62,113)	(19.05)	(62,113)	(19.05)	80.02	11.88	4.82	0.52	(9,467)	(2.66)	(36,835)	(10.35)
OH Totals, 18 Institutions	6,082,105	(8,891)	(0.15)	(208,076)	(3.42)	(288,261)	(4.74)	90.26	23.00	0.81	2.38	2,959	0.05	(149,774)	(2.42)
TN Totals, 8 Institutions	641,762	(16,938)	(2.64)	(50,768)	(7.91)	(62,046)	(9.67)	84.83	14.88	1.81	0.88	(4,188)	(0.64)	(20,902)	(3.18)
IN Totals, 13 Institutions	1,333,051	(55,685)	(4.18)	(112,854)	(8.47)	(123,615)	(9.27)	85.32	9.34	2.91	0.23	(12,804)	(0.93)	(31,452)	(2.29)
MI Totals, 6 Institutions	1,598,421	(79,249)	(4.96)	(118,160)	(7.39)	(173,261)	(10.84)	83.27	11.93	2.54	1.26	(23,214)	(1.44)	(35,750)	(2.22)
IL Totals, 56 Institutions	11,246,006	(176,015)	(1.57)	(588,803)	(5.24)	(932,997)	(8.30)	88.15	13.58	1.93	0.41	(64,331)	(0.62)	(165,030)	(1.60)
WI Totals, 2 Institutions	348,103	(21,851)	(6.28)	(21,851)	(6.28)	(31,177)	(8.96)	82.20	16.19	3.90	3.00	(18,308)	(4.69)	(26,816)	(6.88)
IA Totals, 9 Institutions	1,315,296	(122,658)	(9.33)	(146,104)	(11.11)	(161,833)	(12.30)	82.05	15.53	5.25	0.92	(23,014)	(1.65)	(60,488)	(4.33)
MN Totals, 9 Institutions	4,584,511	20,541	0.45	(201,258)	(4.39)	(426,164)	(9.30)	76.59	21.64	1.51	6.78	(37,608)	(0.84)	(25,171)	(0.56)
MO Totals, 10 Institutions	5,927,664	80,642	1.36	(76,915)	(1.30)	(298,655)	(5.04)	89.76	14.92	2.00	1.72	(61,545)	(1.00)	(66,121)	(1.08)

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GAAP INSOLVENT FSLIC THRIFTS
SELECTED FINANCIAL INFORMATION AT DECEMBER 31, 1987
(Dollars in Thousands)

Institution Name	Total Assets	Regulatory Capital	Reg. Cap./ Assets	Estimated GAAP Cap.	Est. GAAP Capital/ Assets	Tangible Capital	Tangible Capital/ Assets	Int.Earn. Asst/Int. Bear.Liab	Non 1-4 Con/Conv Lns/Assts	Net Repos Assets/ Tot Asst	Serv.Corp Inv./ Tot Asst	Net Oper. Income (Deficit)	Net Op. Inc (Def)/ Avg Asst	Adjusted Net Income (Loss)	Adj. Net Inc(Loss)/ Avg Asst
ND Totals, 2 Institutions	218,753	3,833	1.75	(8,220)	(3.76)	(8,220)	(3.76)	91.14	27.90	2.38	0.23	808	0.35	(2,786)	(1.21)
SD Totals, 2 Institutions	145,258	(1,340)	(0.92)	(5,084)	(3.50)	(5,084)	(3.50)	92.67	18.90	1.47	0.11	825	0.53	(921)	(0.60)
AR Totals, 14 Institutions	4,401,772	(377,498)	(8.58)	(461,392)	(10.48)	(593,294)	(13.48)	80.88	37.73	7.06	1.93	(93,390)	(2.08)	(207,117)	(4.62)
LA Totals, 28 Institutions	4,237,845	(418,847)	(9.88)	(572,828)	(13.52)	(583,650)	(13.77)	76.45	17.70	4.82	1.38	(91,505)	(2.29)	(235,844)	(5.91)
MS Totals, 9 Institutions	1,159,128	17,121	1.48	(34,210)	(2.95)	(78,823)	(6.80)	85.01	12.96	2.79	1.58	(13,780)	(1.17)	(20,141)	(1.71)
NM Totals, 6 Institutions	2,158,891	(141,732)	(6.57)	(161,407)	(7.48)	(244,102)	(11.31)	72.38	35.83	11.64	3.04	(79,732)	(3.70)	(185,072)	(8.58)
TX Totals, 125 Institutions	46,394,099	(8,410,535)	(18.13)	(9,161,798)	(19.75)	(10,503,680)	(22.64)	59.25	32.13	15.75	5.13	(2,841,793)	(6.09)	(6,155,880)	(13.18)
CO Totals, 7 Institutions	560,[illegible]	(123,398)	(22.02)	(126,285)	(22.53)	(126,285)	(22.53)	70.81	23.30	8.34	4.21	(22,782)	(4.69)	(86,063)	(17.73)
KS Totals, 10 Institutions	1,398,398	(76,357)	(5.46)	(106,716)	(7.63)	(120,429)	(8.61)	82.13	17.50	7.48	0.85	(24,158)	(1.74)	(79,623)	(5.74)
NE Totals, 9 Institutions	1,962,621	(66,623)	(3.39)	(1[illegible],302)	(5.16)	(129,709)	(6.61)	82.69	22.01	6.40	0.58	(30,347)	(1.52)	(74,132)	(3.71)
OK Totals, 20 Institutions	3,711,956	(541,312)	(14.58)	(639,855)	(17.24)	(671,489)	(18.09)	77.38	23.90	8.50	0.59	(110,135)	(3.26)	(381,609)	(11.28)
AZ Totals, 1 Institution	798,734	(270,874)	(33.91)	(271,191)	(33.95)	(271,191)	(33.95)	46.82	37.04	9.17	19.29	(56,817)	(6.54)	(92,232)	(10.61)
CA Totals, 32 Institutions	9,703,909	(2,965,524)	(30.56)	(3,851,191)	(39.69)	(3,866,517)	(39.84)	66.82	29.73	5.08	4.80	(551,900)	(5.50)	(1,045,055)	(10.42)
AK Totals, 1 Institution	310,469	(16,405)	(5.28)	(18,478)	(5.95)	(18,662)	(6.01)	91.40	39.08	4.64	0.52	(6,019)	(1.89)	(32,217)	(10.12)
ID Totals, 1 Institution	27,142	(2,368)	(8.72)	(2,368)	(8.72)	(2,368)	(8.72)	82.78	9.65	4.77	0	(379)	(1.23)	(2,042)	(6.62)
MT Totals, 1 Institution	135,458	(2,296)	(1.69)	(9,551)	(7.05)	(9,551)	(7.05)	87.68	11.61	1.68	0.23	(199)	(0.18)	(3,289)	(2.93)
OR Totals, 6 Institutions	1,312,586	(204,572)	(15.59)	(281,499)	(21.45)	(287,022)	(21.87)	72.49	23.33	7.60	1.94	(36,188)	(2.89)	(95,708)	(7.64)
UT Totals, 3 Institutions	2,407,741	(78,799)	(3.27)	(87,854)	(3.65)	(256,578)	(10.66)	78.25	18.64	2.31	3.71	(15,623)	(0.57)	(64,658)	(2.34)
WA Totals, 5 Institutions	778,061	(14,214)	(1.83)	(39,093)	(5.02)	(39,970)	(5.14)	84.58	25.98	5.74	0.83	(6,809)	(0.82)	(29,463)	(3.54)
WY Totals, 2 Institutions	586,820	(60,504)	(10.31)	(65,641)	(11.19)	(65,723)	(11.20)	76.88	19.70	6.14	3.67	(14,432)	(2.35)	(43,016)	(7.01)
Grand Totals, 507 Institutions	142,914,552	(14,836,140)	(10.38)	(19,099,418)	(13.36)	(22,389,968)	(15.67)	73.95	24.19	7.45	3.11	(4,434,642)	(3.12)	(10,049,216)	(7.07)

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GAAP INSOLVENT FSLIC THRIFTS
HISTORICAL & FORECASTED STATEMENTS OF OPERATIONS

(Dollars in Thousands)

	HISTORICAL			FORECASTED			
	1984	1985	1986	1987	1988	1989	1990
Interest Income	$ 10,548,373	$ 11,560,931	$ 11,351,969	$ 10,045,872	$ 10,002,764	$ 10,002,764	$ 10,002,764
Interest Expense	9,980,408	10,870,291	11,308,350	11,062,245	11,638,684	11,993,636	12,375,797
Net Interest Inc. (Exp.)	567,965	690,640	43,619	(1,016,373)	(1,635,920)	(1,990,872)	(2,373,033)
Other Operating Income:							
Mortgage Loan Fees	561,318	528,147	404,874	235,341	236,662	236,662	236,662
Loan Servicing Fees	78,123	128,024	136,487	107,790	108,393	108,393	108,393
Other Loan Fees & Charges	107,730	122,744	124,431	99,675	100,242	100,242	100,242
Ser.Chg. & Fees-Trans.Accts.	64,071	98,233	120,807	134,977	135,705	135,705	135,705
Service Corps./Subsidiaries	167,012	473,547	(353,985)	(602,290)	0	0	0
Other	374,195	385,001	295,804	130,927	131,701	131,701	131,701
Total Oth. Operating Inc.	1,352,449	1,735,696	728,418	106,420	712,703	712,703	712,703
Operating Expense:							
Officers & Employees Comp.	800,922	985,642	1,132,019	1,161,429	1,168,009	1,168,009	1,168,009
Legal Expense	28,846	51,856	100,653	159,409	160,301	160,301	160,301
Office Occ. & Equip. Exp.	405,533	508,166	601,756	668,460	672,235	672,235	672,235
Marketing Expense	105,034	103,678	103,502	98,302	98,812	98,812	98,812
Professional Services	53,431	71,869	127,347	137,888	138,708	138,708	138,708
Amortization of Goodwill	85,876	116,361	235,433	201,746	201,746	201,746	201,746
Other	501,592	865,214	1,124,065	1,097,455	1,103,660	1,103,660	1,103,660
Total Operating Expense	1,981,234	2,702,786	3,424,795	3,524,689	3,543,471	3,543,471	3,543,471
NET OPER. INC. (DEFICIT)	(60,820)	(276,450)	(2,652,758)	(4,434,642)	(4,466,688)	(4,821,640)	(5,203,801)
Non-Operating Income:							
Profit on Sales of REO & Oth	95,785	145,609	117,934	107,442	0	0	0
Profit on Sale of Investments	68,848	302,508	407,924	108,253	0	0	0
Profit on Sale of Loans	109,870	239,458	344,525	207,100	0	0	0
Amortized Deferred Gains	19,183	9,351	6,277	4,652	4,652	4,652	4,652
Other	157,249	248,730	240,251	279,545	0	0	0
Total Non-Operating Inc.	450,935	945,656	1,116,911	706,992	4,652	4,652	4,652
Non-Operating Expense:							
Prov. for Losses on Assets	N/A	N/A	N/A	4,929,015	0	0	0
Loss on Sale of REO & Other	69,274	191,308	737,724	213,537	0	0	0
Loss on Sale of Investments	33,056	66,219	98,862	105,847	0	0	0
Loss on Sale of Loans	141,339	515,635	2,024,174	214,275	0	0	0
Amortized Deferred Losses	71,039	112,084	133,199	168,377	168,377	168,377	168,377
Other	67,596	139,993	357,730	589,788	0	0	0
Total Non-Operating Exp.	382,304	1,025,239	3,351,689	6,220,839	168,377	168,377	168,377
INC.(LOSS) BEF. TAXES & ADJ.	7,811	(356,033)	(4,887,536)	(9,948,489)	(4,630,413)	(4,985,365)	(5,367,526)
Income Taxes (Credits)	20,722	13,437	(95,754)	0	0	0	0
NET INCOME (LOSS) BEF. ADJ.	(13,132)	(369,649)	(4,791,910)	(9,948,489)	(4,630,413)	(4,985,365)	(5,367,526)
Prior Period Adjustments	(36,832)	(399,742)	(1,017,716)	0	0	0	0
ADJUSTED NET INCOME (LOSS)	$ (49,964)	$ (769,387)	$ (5,809,615)	$ (9,948,489)	$ (4,630,413)	$ (4,985,365)	$ (5,367,526)

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GAAP INSOLVENT FSLIC THRIFTS
HISTORICAL & FORECASTED FINANCIAL RATIOS - BALANCE SHEETS
(As a Percent of Total Assets)

	HISTORICAL			FORECASTED			
	1984	1985	1986	1987	1988	1989	1990
ASSETS							
Earning Assets	84.67	82.49	81.31	80.39	80.39	80.39	80.39
Non-Earning Assets	15.33	17.51	18.69	19.61	19.61	19.61	19.61
TOTAL ASSETS	100.00	100.00	100.00	100.00	100.00	100.00	100.00
LIABILITIES							
Interest Bearing Liab.	95.45	95.86	100.20	108.63	111.86	115.35	119.10
Non-Interest Bearing Liab.	1.70	1.71	1.70	1.69	1.69	1.69	1.69
TOTAL LIABILITIES	97.15	97.56	101.90	110.32	113.55	117.04	120.79
REGULATORY CAPITAL							
Preferred Stock	0.08	0.08	0.07	0.07	0.07	0.07	0.07
Perm. Stock & Cont. Cap.	0.54	0.64	0.57	0.61	0.61	0.61	0.61
Qualif. Subordinated Deb.	0.15	0.17	0.17	0.17	0.17	0.17	0.17
Appraised Equity Capital	0.35	0.32	0.37	0.35	0.35	0.35	0.35
Net Worth & Income Cap. Cert.	0.10	0.73	0.89	0.88	0.88	0.88	0.88
Retained Earnings (Deficit)	1.61	0.51	(3.96)	(12.38)	(15.63)	(19.11)	(22.87)
Dividends Paid	(0.11)	(0.03)	(0.02)	(0.01)	0.00	0.00	0.00
TOTAL REGULATORY CAPITAL	2.85	2.44	(1.90)	(10.32)	(13.55)	(17.04)	(20.79)
TOTAL LIABS. & REG. CAP.	100.00	100.00	100.00	100.00	100.00	100.00	100.00

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GAAP INSOLVENT FSLIC THRIFTS
HISTORICAL & FORECASTED FINANCIAL RATIOS - STATEMENTS OF OPERATIONS
(As a Percent of Average Assets)

	HISTORICAL			FORECASTED			
	1984	1985	1986	1987	1988	1989	1990
Interest Income	10.26	9.44	8.31	7.06	7.00	7.00	7.00
Interest Expense	9.71	8.88	8.28	7.78	8.14	8.39	8.65
Net Interest Inc. (Exp.)	0.55	0.56	0.03	(0.71)	(1.14)	(1.39)	(1.66)
Other Operating Income:							
Mortgage Loan Fees	0.55	0.43	0.30	0.17	0.17	0.17	0.17
Loan Servicing Fees	0.08	0.10	0.10	0.08	0.08	0.08	0.08
Other Loan Fees & Charges	0.10	0.10	0.09	0.07	0.07	0.07	0.07
Ser.Chg. & Fees-Trans.Accts.	0.06	0.08	0.09	0.09	0.09	0.09	0.09
Service Corps./Subsidiaries	0.16	0.39	(0.26)	(0.42)	0.00	0.00	0.00
Other	0.36	0.31	0.22	0.09	0.09	0.09	0.09
Total Oth. Operating Inc.	1.32	1.42	0.53	0.07	0.50	0.50	0.50
Operating Expense:							
Officers & Employees Comp.	0.78	0.81	0.83	0.82	0.82	0.82	0.82
Legal Expense	0.03	0.04	0.07	0.11	0.11	0.11	0.11
Office Occ. & Equip. Exp.	0.39	0.42	0.44	0.47	0.47	0.47	0.47
Marketing Expense	0.10	0.08	0.08	0.07	0.07	0.07	0.07
Professional Services	0.05	0.06	0.09	0.10	0.10	0.10	0.10
Amortization of Goodwill	0.08	0.10	0.17	0.14	0.14	0.14	0.14
Other	0.49	0.71	0.82	0.77	0.77	0.77	0.77
Total Operating Expense	1.93	2.21	2.51	2.48	2.48	2.48	2.48
NET OPER. INC. (DEFICIT)	(0.06)	(0.23)	(1.94)	(3.12)	(3.12)	(3.37)	(3.64)
Non-Operating Income:							
Profit on Sales of REO & Oth	0.09	0.12	0.09	0.08	0.00	0.00	0.00
Profit on Sale of Investments	0.07	0.25	0.30	0.08	0.00	0.00	0.00
Profit on Sale of Loans	0.11	0.20	0.25	0.15	0.00	0.00	0.00
Amortized Deferred Gains	0.02	0.01	0.00	0.00	0.00	0.00	0.00
Other	0.15	0.20	0.18	0.20	0.00	0.00	0.00
Total Non-Operating Inc.	0.44	0.77	0.82	0.50	0.00	0.00	0.00
Non-Operating Expense:							
Prov. for Losses on Assets	N/A	N/A	N/A	3.47	0.00	0.00	0.00
Loss on Sale of REO & Other	0.07	0.16	0.54	0.15	0.00	0.00	0.00
Loss on Sale of Investments	0.03	0.05	0.07	0.07	0.00	0.00	0.00
Loss on Sale of Loans	0.14	0.42	1.48	0.15	0.00	0.00	0.00
Amortized Deferred Losses	0.07	0.09	0.10	0.12	0.12	0.12	0.12
Other	0.07	0.11	0.26	0.41	0.00	0.00	0.00
Total Non-Operating Exp.	0.37	0.84	2.45	4.37	0.12	0.12	0.12
INC.(LOSS) BEF. TAXES & ADJ.	0.01	(0.29)	(3.58)	(6.99)	(3.24)	(3.49)	(3.75)
Income Taxes (Credits)	0.02	0.01	(0.07)	0.00	0.00	0.00	0.00
NET INCOME (LOSS) BEFORE ADJ.	(0.01)	(0.30)	(3.51)	(6.99)	(3.24)	(3.49)	(3.75)
Prior Period Adjustments	(0.04)	(0.33)	(0.74)	0.00	0.00	0.00	0.00
ADJUSTED NET INCOME (LOSS)	(0.05)	(0.63)	(4.25)	(6.99)	(3.24)	(3.49)	(3.75)

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GAAP INSOLVENT FSLIC THRIFTS
FORECAST ASSUMPTIONS
(Dollars in Thousands)

		1987	1988	1989	1990
Total Annual Liability Growth		9.4180%	0.0000%	0.0000%	0.0000%
Chg. In Non-Earning Assets	$	0	0	0	0
Chg. In Preferred Stock Issues	$	0	0	0	0
Dividend Rate	F	0.0000%	0.0000%	0.0000%	0.0000%
Pay Yearly-1,Pass-2,Accrue-3		1	1	1	1
Repay. Preferred Stock Issues	$	0	0	0	0
Permanent Stock Infusions	$	0	0	0	0
New Subordinated Debt Issues	$	0	0	0	0
Repay. of Subordinated Debt	$	0	0	0	0
Accrual Rate - Each Issue	F	0.0000%	0.0000%	0.0000%	0.0000%
Appraised Equity Capital Adj.	$	0	0	0	0
N.W. & Inc. Capital Certifs.	$	0	0	0	0
Repay. NW. & Inc. Cap. Cert.	$	0	0	0	0
Interest Rate - Each Issue	F	0.0000%	0.0000%	0.0000%	0.0000%
Non-Cash Capital Infusion	$	0	0	0	0
Dividends Paid	$	0	0	0	0
Retained Earnings Adjustment	$	0	0	0	0
Yield on Exist. Earning Assets		8.7008%	8.7008%	8.7008%	8.7008%
Cost of Funds/Current Liabs.		7.3827%	7.3827%	7.3827%	7.3827%
SPREAD		1.3181%	1.3181%	1.3181%	1.3181%
Yield on New Earning Assets	F	9.5000%	8.7008%	8.7008%	8.7008%
Cost of Funds/New Liabilities		7.0000%	7.3827%	7.3827%	7.3827%
SPREAD		2.5000%	1.3181%	1.3181%	1.3181%
Mtg. Loan Fee/Avg. Assets		0.1655%	0.1655%	0.1655%	0.1655%
Mtg. Loans/Int.Earn.Assets		0.0000%	0.0000%	0.0000%	0.0000%
Yrs. Portfolio Amortization	#	8	8	8	N/A
Avg. Orig. Fee on New Loans		1.0000%	1.0000%	1.0000%	1.0000%
Loan Serv. Fees/Avg. Assets		0.0758%	0.0758%	0.0758%	0.0758%
Mtg. Loans Serv. for Others	$	32,038,719	32,038,719	32,038,719	32,038,719
Avg. Servicing Fee Income		0.0000%	0.0000%	0.0000%	0.0000%
Oth. Loan Fees/Avg. Assets		0.0701%	0.0701%	0.0701%	0.0701%
Fee Inc.-Trans.Ac./Avg. Assets		0.0949%	0.0949%	0.0949%	0.0949%
Trans. Ac./Int. Bear. Liabs.		4.3123%	4.3123%	4.3123%	4.3123%
Transaction Account Fees		0.0000%	0.0000%	0.0000%	0.0000%
Inc. (Loss) - Serv.Corps./Subs.	$	0	0	0	0
Other Operating Inc./Avg. Assets		0.0921%	0.0921%	0.0921%	0.0921%
Off. & Emp. Comp./Avg. Assets		0.8168%	0.8168%	0.8168%	0.8168%
Legal Expense/Avg. Assets		0.1121%	0.1121%	0.1121%	0.1121%
Office Occ.& Equip./Avg.Assets		0.4701%	0.4701%	0.4701%	0.4701%
Marketing Exp./Avg. Assets		0.0691%	0.0691%	0.0691%	0.0691%
Profess. Serv./Avg. Assets		0.0970%	0.0970%	0.0970%	0.0970%
Amortization of Goodwill	$	0	201,746	201,746	201,746
Oth. Oper. Exp./Avg. Assets		0.7718%	0.7718%	0.7718%	0.7718%
Profit on Sales of REO & Oth.	$	0	0	0	0
Profit on Sales of Investments	$	0	0	0	0
Profit on Sales of Loans	$	0	0	0	0
Amortized Deferred Gain	$	0	4,652	4,652	4,652
Other Non-Operating Income	$	0	0	0	0
Provision for Loss - Cash	$	0	0	0	0
Provision for Loss - Non-Cash	$	0	0	0	0
Loss on Sales of REO & Other	$	0	0	0	0
Loss ~~on~~ Sales of Investments	$	0	0	0	0
Loss on Sales of Loans	$	0	0	0	0
Amortized Deferred Loss	$	0	168,377	168,377	168,377
Other Non-Operating Expense	$	0	0	0	0
Income Tax %		0.0000%	0.0000%	0.0000%	0.0000%

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GAAP INS. FSLIC THRIFTS-IEA/IBL>90%

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FINANCIAL HIGHLIGHTS
(Dollars in Thousands)

	1984	1985	1986	1987
Total Assets	$ 27,029,825	$ 27,582,336	$ 28,241,487	29,622,641
% Change in Assets	10.42%	2.04%	2.39%	4.89%
Regulatory Capital	650,448	674,130	709,[illegible]	235,895
Estimated GAAP Capital	(431,112)	(431,049)	(361,433)	(773,026
Tangible Capital	(783,866)	(773,126)	(684,218)	(1,089,252
Regulatory Capital/Total Assets	2.41%	2.44%	2.51%	0.80%
Est. GAAP Capital/Total Assets	(1.59%)	(1.56%)	(1.28%)	(2.61%
Tangible Capital/Total Assets	(2.90%)	(2.80%)	(2.42%)	(3.68%
Net Income (Loss)	(62,577)	18,173	37,536	(327,355
Return on Average Assets	(0.24%)	0.07%	0.13%	(1.13%
Return on Avg. Regulatory Cap.	(9.37%)	2.74%	5.43%	(69.28%
Yield on Loans	11.44%	11.12%	10.64%	9.52%
Yield on Investments	10.82%	9.77%	7.82%	7.51%
Yield on Earning Assets	11.36%	10.94%	10.26%	9.23%
Cost of Savings	9.78%	8.87%	7.83%	6.82%
Cost of Borrowings	11.91%	9.71%	9.15%	7.68%
Cost of Funds	9.99%	8.96%	7.97%	6.93%
Yield/Cost Spread	1.37%	1.98%	2.29%	2.30%
Amt.Elig. for Reg. Liquidity	2,825,412	2,788,169	3,126,440	2,170,274
Amt.Elig. for Reg.Liq./Tot.Assets	10.45%	10.11%	11.07%	7.33%
Int.Earn.Asst./Int.Bear.Liab.	92.30%	92.21%	92.42%	92.44%
Loans & Participations Purchased	1,427,067	1,354,470	984,192	890,467
Loans & Participations Sold	2,679,153	1,815,235	2,837,610	1,827,614
Mortg. Loans Serviced for Others	5,102,586	6,564,156	7,428,880	7,539,078
Mortg. Loans Serviced by Others	3,846,813	3,964,897	3,464,039	3,397,038
Broker Originated Deposits	119,899	95,202	79,326	140,283
Cash Div. on Preferred Stock	0	0	0	0
Cash Div. on Permanent Stock	449	552	146	0
Cash Div. on Other Cap. Inst.	6	57	164	151
Non 1-4 Con./Conv.Ins./Tot.Asst	16.04%	16.92%	16.20%	16.85%
Balloon & Adj. Rate Loans	5,107,838	6,904,173	7,178,478	8,743,744
Ser.Corp.Inc./Inv.in Ser.Corp.	4.00%	6.00%	(11.32%)	(9.62%)
OTHER INFORMATION				
Annual Closing Date	N/A	N/A	N/A	N/A
No. of Wholly-Owned Ser. Corps.	147	160	163	173
No. of Deposit Accounts	3,941,004	3,820,999	3,773,504	3,770,171

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GAAP INS. FSLIC THRIFTS-IEA/IBL>90%
BALANCE SHEETS
(Dollars in Thousands)

ASSETS	1984	1985	1986	1987
Construction Loans On:				
1-4 Dwelling Units	$ N/A	$ N/A	$ N/A	$ 493,010
5 or More Dwelling Units	N/A	N/A	N/A	238,321
Nonresidential	N/A	N/A	N/A	436,052
Permanent Mortgages On:				
1-4 Dwelling Units	11,165,338	11,661,245	10,768,540	11,250,998
5 or More Dwelling Units	1,323,895	1,377,882	1,316,352	1,125,123
Nonresidential (Except Land)	2,483,815	2,803,797	2,796,364	2,791,254
Dev. Bldg. Lots, Land, Etc.	528,191	486,045	461,358	399,435
Mortgage Backed Securities	3,327,482	2,968,574	3,951,695	4,747,936
Accrued Interest Receivable	209,234	231,499	230,795	261,845
Other Mortgage Receivables	1,101,669	934,139	847,941	117,363
Loans in Process	(548,420)	(545,897)	(511,459)	(396,593)
Unearned Disc. & Def. Loan Fees	(281,207)	(189,831)	(117,942)	(108,678)
Specific Reserves & Val. Allow.	(48,317)	(99,618)	(166,126)	(394,417)
Net Mortgage Loans	19,261,678	19,627,839	19,577,515	20,961,647
Commercial Loans	193,462	276,501	324,899	310,925
Consumer Loans	1,300,165	1,535,051	1,559,258	1,595,354
Financing Leases	38,771	53,361	81,413	121,345
Accrued Interest Receivable	14,356	19,520	20,949	22,062
Loans in Process	(1,799)	(1,279)	(1,467)	(938)
Unearned Disc. & Def. Loan Fees	(56,627)	(21,419)	(17,300)	(12,487)
Specific Reserves & Val. Allow.	(5,828)	(11,487)	(17,008)	(52,014)
Net Nonmortgage Loans	1,482,526	1,850,246	1,950,744	1,984,246
Repossessed Assets	152,530	217,341	319,282	422,275
Valuation Allowances	(14,594)	(24,193)	(42,299)	(96,068)
Net Repossessed Assets	137,936	193,148	276,983	326,207
Real Estate Held For Dev., Etc.	15,823	17,957	58,206	72,480
Valuation Allowances	(354)	(429)	(2,105)	(6,612)
Net Real Estate Held for Dev.	15,469	17,528	56,101	65,868
Cash & Demand Deposits	326,815	313,130	381,606	317,034
U.S. Govt. & Agency Securities	1,574,980	998,439	1,194,729	1,451,044
Equity Sec., Except FHLB/FHLMC	N/A	11,055	6,213	6,745
Other Investments	1,803,005	2,074,633	2,377,031	2,162,781
Accrued Interest Receivable	53,278	35,927	40,838	45,317
Valuation Allowances	(135)	(331)	(455)	(5,178)
Net Cash & Investment Sec.	3,757,943	3,432,853	3,999,962	3,977,743
Net Fixed Assets	377,640	384,538	385,285	399,603
Investment in Ser. Corps./Subs.	275,834	285,873	311,898	286,625
Deferred Net Losses (Gains)	923,261	944,167	894,499	823,346
Intangible Assets	352,754	342,077	322,785	316,226
Other Assets	444,802	504,047	465,686	481,128
TOTAL ASSETS	$ 27,029,825	$ 27,582,336	$ 28,241,487	$ 29,622,641

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GAAP INS. FSLIC THRIFTS-IEA/IBL>90%
BALANCE SHEETS
(Dollars in Thousands)

LIABILITIES	1984	1985	1986	1987
Fixed-Maturity Deposits	$ 17,291,540	$ 17,113,309	$ 16,348,397	$ 16,973,393
Transaction Accounts	805,171	958,111	1,292,498	1,522,201
Money Market Deposit Accounts	2,941,077	3,494,088	3,653,560	3,172,092
Passbook Accounts	2,184,426	2,169,035	2,529,746	2,816,991
Total Savings Deposits	23,222,214	23,734,543	23,824,201	24,484,677
FHLB Advances	1,718,689	1,702,833	2,031,574	2,321,004
Repurchase Agreements	715,149	578,834	458,521	730,242
Commercial Paper Issued	0	0	0	0
Sub.Deb. not Qual. as Reg.Cap.	35,525	595	15,670	15,740
Mortgage-Backed Bonds Issued	88,488	164,077	235,125	822,005
Other Borrowings	169,061	299,321	519,456	536,003
Other Liabilities	430,259	427,998	447,857	477,075
TOTAL LIABILITIES	26,379,377	26,908,206	27,532,426	29,386,747
REGULATORY CAPITAL				
Preferred Stock	0	0	227	0
Permanent Stock	3,516	4,334	4,151	4,385
Contributed Capital	16,060	19,772	19,809	19,810
Qualifying Mutual Cap. Cert.	0	0	0	0
Qualifying Subordinated Deb.	2,690	3,120	3,045	2,975
Appraised Equity Capital	88,270	94,092	99,712	98,988
Net Worth & Income Cap. Cert.	81,215	85,825	98,325	98,325
Retained Earnings (Deficit)	458,709	466,988	483,790	11,413
TOTAL REGULATORY CAPITAL	650,448	674,130	709,060	235,895
TOTAL LIAB. & REG. CAPITAL	$ 27,029,825	$ 27,582,336	$ 28,241,486	$ 29,622,643

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GAAP INS. FSLIC THRIFTS-IEA/IBL>90%
STATEMENTS OF OPERATIONS
(Dollars in Thousands)

	1984	1985	1986	1987
Interest Income	$ 2,619,319	$ 2,646,147	$ 2,536,703	$ 2,394,018
Interest Expense	2,465,730	2,348,727	2,137,043	1,961,907
Net Interest Inc. (Exp.)	153,589	297,420	399,660	432,111
Other Operating Income:				
Mortgage Loan Fees	92,251	86,180	99,067	74,568
Loan Servicing Fees	11,184	17,383	20,303	23,880
Other Loan Fees & Charges	19,477	24,081	28,278	25,217
Ser.Chgs. & Fees - Trans.Accts.	13,220	18,551	22,435	26,091
Service Corps./Subsidiaries	8,937	16,838	(33,839)	(28,775)
Other	72,772	51,692	35,943	24,954
Total Oth. Operating Income	217,841	214,725	172,187	145,935
Operating Expense:				
Officers & Employees Comp.	178,538	197,095	220,111	236,964
Legal Expense	4,933	6,359	8,486	11,462
Office Occ. & Equip. Expense	86,002	96,086	108,603	116,992
Marketing Expense	25,295	21,162	21,389	22,192
Professional Services	9,375	11,703	12,789	16,232
Amortization of Goodwill	12,242	12,181	11,784	11,717
Other	100,121	146,394	165,459	171,030
Total Operating Expense	416,506	490,980	548,621	586,589
NET OPER. INCOME (DEFICIT)	(45,076)	21,165	23,226	(8,543)
Non-Operating Income:				
Profit on Sale of REO & Other	12,090	11,608	9,320	12,403
Profit on Sale of Investments	23,503	85,762	126,312	27,656
Profit on Sale of Loans	7,313	41,884	95,765	49,229
Amortized Deferred Gains	1,128	1,612	2,271	1,160
Other	33,246	29,555	26,862	17,640
Total Non-Operating Income	77,280	170,421	260,530	108,088
Non-Operating Expense:				
Provision for Losses on Assets	N/A	N/A	N/A	256,713
Loss on Sale of REO & Other	14,105	21,993	36,998	21,152
Loss on Sale of Investments	12,427	15,767	12,999	24,323
Loss on Sale of Loans	18,989	50,790	78,751	16,065
Amortized Deferred Losses	26,172	39,082	46,550	49,899
Other	13,431	19,427	23,136	46,382
Total Non-Operating Expense	85,124	147,059	198,434	414,534
INCOME (LOSS) BEF. TAXES & ADJ.	(52,920)	44,527	85,322	(314,989)
Income Taxes (Credits)	1,936	6,715	26,052	6,782
NET INCOME (LOSS) BEFORE ADJ.	(54,862)	37,769	59,255	(321,762)
Prior Period Adjustments	(7,716)	(19,596)	(21,722)	(5,588)
ADJUSTED NET INCOME (LOSS)	$ (62,577)	$ 18,173	$ 37,536	$ (327,355)

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GAAP INS. FSLIC THRIFTS-IEA/IBL>90%
FINANCIAL RATIOS - BALANCE SHEETS
(As a Percent of Total Assets)

ASSETS	1984	1985	1986	1987
Construction Loans On:				
1-4 Dwelling Units	N/A	N/A	N/A	1.66
5 or More Dwelling Units	N/A	N/A	N/A	0.80
Nonresidential	N/A	N/A	N/A	1.47
Permanent Mortgages On:				
1-4 Dwelling Units	41.31	42.28	38.13	37.98
5 or More Dwelling Units	4.90	5.00	4.66	3.80
Nonresidential (Except Land)	9.19	10.17	9.90	9.42
Dev. Bldg. Lots, Land, Etc.	1.95	1.76	1.63	1.35
Mortgage Backed Securities	12.31	10.76	13.99	16.03
Accrued Interest Receivable	0.77	0.84	0.82	0.88
Other Mortgage Receivables	4.08	3.39	3.00	0.40
Loans in Process	(2.03)	(1.98)	(1.81)	(1.34)
Unearned Disc. & Def. Loan Fees	(1.04)	(0.69)	(0.42)	(0.37)
Specific Reserves & Val. Allow.	(0.18)	(0.36)	(0.59)	(1.33)
Net Mortgage Loans	71.26	71.16	69.32	70.76
Commercial Loans	0.72	1.00	1.15	1.05
Consumer Loans	4.81	5.57	5.52	5.39
Financing Leases	0.14	0.19	0.29	0.41
Accrued Interest Receivable	0.05	0.07	0.07	0.07
Loans in Process	(0.01)	0.00	(0.01)	0.00
Unearned Disc. & Def. Loan Fees	(0.21)	(0.08)	(0.06)	(0.04)
Specific Reserves & Val. Allow.	(0.02)	(0.04)	(0.06)	(0.18)
Net Nonmortgage Loans	5.48	6.71	6.91	6.70
Repossessed Assets	0.56	0.79	1.13	1.43
Valuation Allowances	(0.05)	(0.09)	(0.15)	(0.32)
Net Repossessed Assets	0.51	0.70	0.98	1.10
Real Estate Held For Dev., Etc.	0.06	0.07	0.21	0.24
Valuation Allowances	0.00	0.00	(0.01)	(0.02)
Net Real Estate Held for Dev.	0.06	0.06	0.20	0.22
Cash & Demand Deposits	1.21	1.14	1.35	1.07
U.S. Govt. & Agency Securities	5.83	3.62	4.23	4.90
Equity Sec., Except FHLB/FHLMC	N/A	0.04	0.02	0.02
Other Investments	6.67	7.52	8.42	7.30
Accrued Interest Receivable	0.20	0.13	0.14	0.15
Valuation Allowances	0.00	0.00	0.00	(0.02)
Net Cash & Investment Sec.	13.90	12.45	14.16	13.43
Net Fixed Assets	1.40	1.39	1.36	1.35
Investment in Ser. Corps./Subs.	1.02	1.04	1.10	0.97
Deferred Net Losses (Gains)	3.42	3.42	3.17	2.78
Intangible Assets	1.31	1.24	1.14	1.07
Other	1.65	1.83	1.65	1.62
TOTAL ASSETS	100.00	100.00	100.00	100.00

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GAAP INS. FSLIC THRIFTS-IEA/IBL>90%
FINANCIAL RATIOS - BALANCE SHEETS
(As a Percent of Total Assets)

LIABILITIES	1984	1985	1986	1987
Fixed-Maturity Deposits	63.97	62.04	57.89	57.30
Transaction Accounts	2.98	3.47	4.58	5.14
Money Market Deposit Accounts	10.88	12.67	12.94	10.71
Passbook Accounts	8.08	7.86	8.96	9.51
Total Savings Deposits	85.91	86.05	84.36	82.66
FHLB Advances	6.36	6.17	7.19	7.84
Repurchase Agreements	2.65	2.10	1.62	2.47
Commercial Paper Issued	0.00	0.00	0.00	0.00
Sub. Deb. not Qual. as Reg. Cap.	0.13	0.00	0.06	0.05
Mortgage-Backed Bonds Issued	0.33	0.59	0.83	2.77
Other Borrowings	0.63	1.09	1.84	1.81
Other Liabilities	1.59	1.55	1.59	1.61
TOTAL LIABILITIES	97.59	97.56	97.49	99.20
REGULATORY CAPITAL				
Preferred Stock	0.00	0.00	0.00	0.00
Permanent Stock	0.01	0.02	0.01	0.01
Contributed Capital	0.06	0.07	0.07	0.07
Qualifying Mutual Cap. Cert.	0.00	0.00	0.00	0.00
Qualifying Subordinated Deb.	0.01	0.01	0.01	0.01
Appraised Equity Capital	0.33	0.34	0.35	0.33
Net Worth & Income Cap. Cert.	0.30	0.31	0.35	0.33
Retained Earnings (Deficit)	1.70	1.69	1.71	0.04
TOTAL REGULATORY CAPITAL	2.41	2.44	2.51	0.80
TOTAL LIABILITIES & REG. CAP.	100.00	100.00	100.00	100.00

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GAAP INSOLVENT FSLIC THRIFTS WITH IEA/IBL > 90%
SELECTED FINANCIAL INFORMATION AT DECEMBER 31, 1987
(Dollars in Thousands)

Institution Name	Total Assets	Regulatory Capital	Reg. Cap./ Assets	Estimated GAAP Cap.	Est. GAAP Capital/ Assets	Tangible Capital	Tangible Capital/ Assets	Int.Earn. Asst/Int. Bear.Liab	Non 1-4 Con/Conv Lns/Assts	Net Repos Assets/ Tot Asst	Serv.Corp Inv./ Tot Asst	Net Oper. Income (Deficit)	Net Op. Inc (Def)/ Avg Asst	Adjusted Net Income (Loss)	Adj. Net Inc(Loss)/ Avg Asst
CT Totals, 1 Institution	153,017	(6,697)	(4.38)	(10,227)	(6.68)	(10,227)	(6.68)	91.25	11.16	0	(0.04)	(4,457)	(2.92)	(4,909)	(3.21)
MA Totals, 1 Institution	192,650	9,652	5.01	(154)	(0.08)	(154)	(0.08)	93.67	6.19	0.88	0.01	2,519	1.44	1,376	0.79
NJ Totals, 8 Institutions	1,505,203	64,432	4.28	(23,839)	(1.58)	(25,364)	(1.69)	94.28	12.51	0.34	0.69	15,442	1.02	3,868	0.26
NY Totals, 3 Institutions	1,232,458	37,448	3.04	(20,053)	(1.63)	(47,983)	(3.89)	93.01	27.22	0.05	1.06	13,245	1.09	(647)	(0.05)
PR Totals, 1 Institution	26,739	12	0.04	(53)	(0.20)	(53)	(0.20)	92.17	9.71	0.79	0	32	0.12	(182)	(0.68)
PA Totals, 4 Institutions	555,677	(1,404)	(0.25)	(14,020)	(2.52)	(16,070)	(2.89)	94.01	25.41	0.93	0.42	(612)	(0.11)	(5,469)	(0.98)
AL Totals, 2 Institutions	763,825	(815)	(0.11)	(15,876)	(2.08)	(15,876)	(2.08)	91.89	12.61	0.61	1.38	1,926	0.25	(4,866)	(0.62)
FL Totals, 4 Institutions	750,027	17,663	2.35	(26,839)	(3.58)	(28,376)	(3.78)	91.57	10.97	1.12	0.47	1,488	0.20	(2,039)	(0.27)
GA Totals, 6 Institutions	821,554	11,259	1.37	(9,253)	(1.13)	(13,141)	(1.60)	93.52	14.14	0.57	0.33	4,239	0.52	(1)	0.00
MD Totals, 3 Institutions	222,654	8,751	3.93	(2,126)	(0.95)	(2,126)	(0.95)	95.43	24.35	1.54	0.37	1,564	0.68	(1,035)	(0.45)
NC Totals, 3 Institutions	703,956	24,985	3.55	(15,661)	(2.22)	(15,697)	(2.23)	93.96	27.92	0.49	1.08	7,332	1.02	1,476	0.21
SC Totals, 3 Institutions	1,445,846	12,632	0.87	(33,095)	(2.29)	(33,095)	(2.29)	92.66	17.54	0.38	0.89	3,603	0.25	(5,468)	(0.37)
VA Totals, 3 Institutions	1,786,414	13,548	0.76	(40,180)	(2.25)	(40,180)	(2.25)	91.74	14.66	1.74	1.04	(9,608)	(0.56)	(17,876)	(1.04)
KY Totals, 1 Institution	114,715	721	0.63	(2,158)	(1.88)	(2,158)	(1.88)	90.17	16.52	1.43	0.24	(476)	(0.40)	(1,814)	(1.52)
OH Totals, 11 Institutions	3,229,034	(66,955)	(2.07)	(128,384)	(3.98)	(147,722)	(4.57)	91.54	30.03	0.68	2.50	(2,825)	(0.09)	(130,172)	(3.95)
TN Totals, 2 Institutions	195,944	(559)	(0.29)	(5,900)	(3.01)	(6,075)	(3.10)	91.73	13.50	2.22	1.11	(362)	(0.19)	(5,226)	(2.74)
IN Totals, 5 Institutions	677,197	(2,143)	(0.32)	(24,165)	(3.57)	(24,165)	(3.57)	91.67	5.28	1.67	0.06	1,189	0.17	(1,399)	(0.21)
MI Totals, 1 Institution	202,114	(1,867)	(0.92)	(3,331)	(1.65)	(3,331)	(1.65)	94.61	10.32	0.38	0.03	1,387	0.66	1,769	0.84
IL Totals, 31 Institutions	6,416,920	(39,689)	(0.62)	(263,764)	(4.11)	(301,559)	(4.70)	93.33	16.68	1.45	0.16	1,430	0.03	(55,319)	(1.02)
IA Totals, 2 Institutions	413,190	1,043	0.25	(8,010)	(1.94)	(8,010)	(1.94)	91.99	6.48	2.74	0.68	985	0.23	(7,687)	(1.78)
MN Totals, 4 Institutions	406,470	(3,203)	(0.79)	(14,097)	(3.47)	(14,097)	(3.47)	93.10	19.06	1.58	0.21	731	0.18	(6,685)	(1.60)
MO Totals, 6 Institutions	4,622,449	103,760	2.24	(41,402)	(0.90)	(263,142)	(5.69)	90.89	11.01	0.65	1.87	(44,508)	(0.92)	(32,462)	(0.67)
ND Totals, 1 Institution	65,317	2,658	4.07	(411)	(0.63)	(411)	(0.63)	97.67	32.06	0.66	0.10	802	1.22	(183)	(0.28)
SD Totals, 2 Institutions	145,258	(1,340)	(0.92)	(5,084)	(3.50)	(5,084)	(3.50)	92.67	18.90	1.47	0.11	825	0.53	(921)	(0.60)

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GAAP INSOLVENT FSLIC THRIFTS WITH IEA/IBL > 90%
SELECTED FINANCIAL INFORMATION AT DECEMBER 31, 1987
(Dollars in Thousands)

Institution Name	Total Assets	Regulatory Capital	Reg. Cap./ Assets	Estimated GAAP Cap.	Est. GAAP Capital/ Assets	Tangible Capital	Tangible Capital/ Assets	Int.Earn. Asst/Int. Bear.Liab	Non 1-4 Con/Conv Lns/Assts	Net Repos Assets/ Tot Asst	Serv.Corp Inv./ Tot Asst	Net Oper. Income (Deficit)	Net Op. Inc (Def)/ Avg Asst	Adjusted Net Income (Loss)	Adj. Net Inc(Loss)/ Avg Asst
LA Totals, 4 Institutions	443,970	13,363	3.01	(8,922)	(2.01)	(8,950)	(2.02)	91.26	13.27	1.89	0.80	(154)	(0.03)	(9,458)	(2.12)
MS Totals, 4 Institutions	907,485	33,533	3.70	(16,493)	(1.82)	(16,493)	(1.82)	92.76	11.04	1.45	0.85	739	0.08	(3,024)	(0.33)
TX Totals, 3 Institutions	271,020	8,209	3.03	(6,797)	(2.51)	(6,797)	(2.51)	91.30	14.14	2.77	0.37	1,390	0.51	493	0.18
CO Totals, 3 Institutions	214,688	(1,404)	(0.65)	(3,828)	(1.78)	(3,828)	(1.78)	91.73	14.02	2.88	0.20	(607)	(0.28)	(3,378)	(1.55)
KS Totals, 1 Institution	224,519	311	0.14	(3,153)	(1.40)	(3,153)	(1.40)	92.23	6.97	2.72	1.64	(992)	(0.45)	(1,642)	(0.74)
NE Totals, 4 Institutions	346,375	10,193	2.94	(2,905)	(0.84)	(2,905)	(0.84)	94.33	9.30	2.39	0.16	1,171	0.32	511	0.14
OK Totals, 1 Institution	39,521	(20)	(0.05)	(1,802)	(4.56)	(1,802)	(4.56)	91.13	0.53	3.22	0	(70)	(0.18)	(953)	(2.41)
AK Totals, 1 Institution	310,469	(16,405)	(5.28)	(18,478)	(5.95)	(18,662)	(6.01)	91.40	39.08	4.64	0.52	(6,019)	(1.89)	(32,217)	(10.12)
OR Totals, 1 Institution	176,848	3,381	1.91	(2,517)	(1.42)	(2,517)	(1.42)	92.72	13.42	1.95	0.17	(74)	(0.05)	(966)	(0.63)
UT Totals, 1 Institution	39,118	842	2.15	(49)	(0.13)	(49)	(0.13)	91.69	21.67	0.46	2.21	182	0.44	(850)	(2.07)
Grand Totals, 131 Institutions	29,622,641	235,895	0.80	(773,026)	(2.61)	(1,089,252)	(3.68)	92.44	16.85	1.10	0.77	(8,543)	(0.03)	(327,355)	(1.13)

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GAAP INS. FSLIC THRIFTS-IEA/IBL>90%
FINANCIAL RATIOS - STATEMENTS OF OPERATIONS
(As a Percent of Average Assets)

	1984	1985	1986	1987
Interest Income	10.17	9.69	9.09	8.27
Interest Expense	9.57	8.60	7.66	6.78
Net Interest Inc. (Exp.)	0.60	1.09	1.43	1.49
Other Operating Income:				
Mortgage Loan Fees	0.36	0.32	0.35	0.26
Loan Servicing Fees	0.04	0.06	0.07	0.08
Other Loan Fees & Charges	0.08	0.09	0.10	0.09
Ser.Chgs. & Fees-Trans.Accts	0.05	0.07	0.08	0.09
Service Corps./Subsidiaries	0.03	0.06	(0.12)	(0.10)
Other	0.28	0.19	0.13	0.09
Total Oth. Operating Income	0.85	0.79	0.62	0.50
Operating Expense:				
Officers & Employees Comp.	0.69	0.72	0.79	0.82
Legal Expense	0.02	0.02	0.03	0.04
Office Occ. & Equip. Expense	0.33	0.35	0.39	0.40
Marketing Expense	0.10	0.08	0.08	0.08
Professional Services	0.04	0.04	0.05	0.06
Amortization of Goodwill	0.05	0.04	0.04	0.04
Other	0.39	0.54	0.59	0.59
Total Operating Expense	1.62	1.80	1.97	2.03
NET OPER. INCOME (DEFICIT)	(0.18)	0.08	0.08	(0.03)
Non-Operating Income:				
Profit on Sale of REO & Other	0.05	0.04	0.03	0.04
Profit on Sale of Investments	0.09	0.31	0.45	0.10
Profit on Sale of Loans	0.03	0.15	0.34	0.17
Amortized Deferred Gains	0.00	0.01	0.01	0.00
Other	0.13	0.11	0.10	0.06
Total Non-Operating Income	0.30	0.62	0.93	0.37
Non-Operating Expense:				
Provision for Losses on Assets	N/A	N/A	N/A	0.89
Loss on Sale of REO & Other	0.05	0.08	0.13	0.07
Loss on Sale of Investments	0.05	0.06	0.05	0.08
Loss on Sale of Loans	0.07	0.19	0.28	0.06
Amortized Deferred Losses	0.10	0.14	0.17	0.17
Other	0.05	0.07	0.08	0.16
Total Non-Operating Expense	0.33	0.54	0.71	1.43
INCOME (LOSS) BEF. TAXES & ADJ.	(0.21)	0.16	0.31	(1.09)
Income Taxes (Credits)	0.01	0.02	0.09	0.02
NET INCOME (LOSS) BEFORE ADJ.	(0.21)	0.14	0.21	(1.11)
Prior Period Adjustments	(0.03)	(0.07)	(0.08)	(0.02)
ADJUSTED NET INCOME (LOSS)	(0.24)	0.07	0.13	(1.13)

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GAAP INS. FSLIC THRIFTS-IEA/IBL>90%
QUARTERLY STATEMENTS OF OPERATIONS
(Dollars in Thousands)

	3/31/87	6/30/87	9/30/87	12/31/87
Interest Income	$ 585,199	$ 576,908	$ 617,664	$ 614,247
Interest Expense	471,859	464,251	509,638	516,159
Net Interest Inc. (Exp.)	113,340	112,657	108,026	98,088
Other Operating Income:				
Mortgage Loan Fees	16,316	25,088	18,690	14,474
Loan Servicing Fees	5,998	5,150	6,666	6,066
Other Loan Fees & Charges	5,645	6,761	6,735	6,076
Ser.Chgs. & Fees-Trans.Accts	6,007	6,157	6,789	7,138
Service Corps./Subsidiaries	(13,706)	(12,598)	(2,249)	(222)
Other	9,884	2,822	6,377	5,871
Total Oth. Operating Income	30,144	33,380	43,008	39,403
Operating Expense:				
Officers & Employees Comp.	56,820	57,246	61,246	61,652
Legal Expense	2,378	2,628	2,956	3,500
Office Occ. & Equip. Expense	28,585	28,114	29,880	30,413
Marketing Expense	5,156	5,230	5,812	5,994
Professional Services	3,254	3,843	4,382	4,753
Amortization of Goodwill	2,907	2,901	2,964	2,945
Other	40,460	44,555	42,303	43,712
Total Operating Expense	139,560	144,517	149,543	152,969
NET OPER. INCOME (DEFICIT)	3,924	1,520	1,491	(15,478)
Non-Operating Income:				
Profit on Sale of REO & Other	3,104	2,753	2,913	3,633
Profit on Sale of Investments	15,166	5,458	4,680	2,352
Profit on Sale of Loans	33,315	6,748	5,732	3,434
Amortized Deferred Gains	315	436	246	163
Other	2,460	6,167	3,405	5,608
Total Non-Operating Income	54,360	21,562	16,976	15,190
Non-Operating Expense:				
Provision for Losses on Assets	41,316	38,434	18,049	158,914
Loss on Sale of REO & Other	4,564	5,792	5,175	5,621
Loss on Sale of Investments	3,431	14,673	4,179	2,040
Loss on Sale of Loans	4,144	6,591	2,707	2,623
Amortized Deferred Losses	12,051	12,300	12,321	13,227
Other	5,413	30,232	3,973	6,764
Total Non-Operating Expense	70,919	108,022	46,404	189,189
INCOME (LOSS) BEF. TAXES & ADJ.	(12,635)	(84,940)	(27,937)	(189,477)
Income Taxes (Credits)	8,111	691	(814)	(1,206)
NET INCOME (LOSS) BEFORE ADJ.	(20,738)	(85,627)	(27,124)	(188,273)
Prior Period Adjustments	(1,370)	(2,817)	(2,085)	684
ADJUSTED NET INCOME (LOSS)	$ (22,111)	$ (88,445)	$ (29,209)	$ (187,590)

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GAAP INS. FSLIC THRIFTS-IEA/IBL>90%
FINANCIAL RATIOS - QUARTERLY STATEMENTS OF OPERATIONS
(As a Percent of Average Assets)

	3/31/87	6/30/87	9/30/87	12/31/87
Interest Income	8.09	7.98	8.54	8.49
Interest Expense	6.52	6.42	7.05	7.14
Net Interest Inc. (Exp.)	1.57	1.56	1.49	1.36
Other Operating Income:				
Mortgage Loan Fees	0.23	0.35	0.26	0.20
Loan Servicing Fees	0.08	0.07	0.09	0.08
Other Loan Fees & Charges	0.08	0.09	0.09	0.08
Ser.Chgs. & Fees-Trans.Accts	0.08	0.09	0.09	0.10
Service Corps./Subsidiaries	(0.19)	(0.17)	(0.03)	(0.00)
Other	0.14	0.04	0.09	0.08
Total Other Oper. Income	0.42	0.46	0.59	0.54
Operating Expense:				
Officers & Employees Comp.	0.79	0.79	0.85	0.85
Legal Expense	0.03	0.04	0.04	0.05
Office Occ. & Equip. Expense	0.40	0.39	0.41	0.42
Marketing Expense	0.07	0.07	0.08	0.08
Professional Services	0.04	0.05	0.06	0.07
Amortization of Goodwill	0.04	0.04	0.04	0.04
Other	0.56	0.62	0.58	0.60
Total Operating Expense	1.93	2.00	2.07	2.11
NET OPER. INCOME (DEFICIT)	0.05	0.02	0.02	(0.21)
Non-Operating Income:				
Profit on Sale of REO & Other	0.04	0.04	0.04	0.05
Profit on Sale of Investments	0.21	0.08	0.06	0.03
Profit on Sale of Loans	0.46	0.09	0.08	0.05
Amortized Deferred Gains	0.00	0.01	0.00	0.00
Other	0.03	0.09	0.05	0.08
Total Non-Operating Income	0.75	0.30	0.23	0.21
Non-Operating Expense:				
Provision for Losses on Assets	0.57	0.53	0.25	2.20
Loss on Sale of REO & Other	0.06	0.08	0.07	0.08
Loss on Sale of Investments	0.05	0.20	0.06	0.03
Loss on Sale of Loans	0.06	0.09	0.04	0.04
Amortized Deferred Losses	0.17	0.17	0.17	0.18
Other	0.07	0.42	0.05	0.09
Total Non-Operating Expense	0.98	1.49	0.64	2.62
INCOME (LOSS) BEF. TAXES & ADJ.	(0.17)	(1.17)	(0.39)	(2.62)
Income Taxes (Credits)	0.11	0.01	(0.01)	(0.02)
NET INCOME (LOSS) BEFORE ADJ.	(0.29)	(1.18)	(0.38)	(2.60)
Prior Period Adjustments	(0.02)	(0.04)	(0.03)	0.01
ADJUSTED NET INCOME (LOSS)	(0.31)	(1.22)	(0.40)	(2.59)

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GAAP INS. FSLIC THRIFTS-IEA/IBL>90%
HISTORICAL & FORECASTED BALANCE SHEETS
(Dollars in Thousands)

	HISTORICAL			FORECASTED			
	1984	1985	1986	1987	1988	1989	1990
ASSETS							
Earning Assets	$ 23,951,426	$ 24,416,888	$ 25,032,523	$ 26,736,332	$ 26,736,332	$ 26,736,332	$ 26,736,332
Non-Earning Assets	3,078,399	3,165,448	3,208,964	2,898,526	2,898,526	2,898,526	2,898,526
TOTAL ASSETS	$ 27,029,825	$ 27,582,336	$ 28,241,487	$ 29,634,858	$ 29,634,858	$ 29,634,858	$ 29,634,858
LIABILITIES							
Interest Bearing Liab.	$ 25,949,120	$ 26,480,204	$ 27,084,558	$ 28,909,661	$ 28,916,958	$ 28,924,778	$ 28,933,161
Non-Interest Bearing Liab.	430,257	428,002	447,868	477,086	477,086	477,086	477,086
TOTAL LIABILITIES	26,379,377	26,908,206	27,532,426	29,386,747	29,394,044	29,401,864	29,410,247
REGULATORY CAPITAL							
Preferred Stock	0	0	227	0	0	0	0
Perm. Stock & Cont. Cap.	19,576	24,106	23,960	24,195	24,195	24,195	24,195
Qualif. Subordinated Deb.	2,690	3,120	3,065	2,975	2,975	2,975	2,975
Appraised Equity Capital	88,270	94,092	99,712	98,988	98,988	98,988	98,988
Net Worth & Income Cap. Cert.	81,215	85,825	98,325	98,325	98,325	98,325	98,325
Retained Earnings (Deficit)	458,709	466,988	483,790	23,779	16,331	8,511	128
Dividends Paid	(455)	(609)	(318)	(151)	0	0	0
TOTAL REGULATORY CAPITAL	650,448	674,130	709,060	248,111	240,814	232,994	224,611
TOTAL LIABS. & REG. CAP.	$ 27,029,825	$ 27,582,336	$ 28,241,486	$ 29,634,858	$ 29,634,858	$ 29,634,858	$ 29,634,858

HISTORICAL & FORECASTED SELECTED FINANCIAL HIGHLIGHTS

	HISTORICAL			FORECASTED			
	1984	1985	1986	1987	1988	1989	1990
Average Assets	$ 25,754,217	$ 27,306,081	$ 27,911,912	$ 28,938,173	$ 29,634,858	$ 29,634,858	$ 29,634,858
% Change in Assets	10.42	2.04	2.39	4.93	0.00	0.00	0.00
Reg. Capital/Total Assets	2.41	2.44	2.51	0.84	0.81	0.79	0.76
Return on Average Assets	(0.24)	0.07	0.13	(1.09)	(0.02)	(0.03)	(0.03)
Return on Average Reg. Cap.	(9.37)	2.74	5.43	(65.82)	(2.98)	(3.30)	(3.66)
Yield on Earning Assets	11.36	10.94	10.26	9.25	9.23	9.23	9.23
Cost of Funds	9.99	8.96	7.97	7.01	6.93	6.93	6.93
Yield/Cost Spread	1.37	1.98	2.29	2.24	2.30	2.30	2.30
Int.Earn.Asst./Int.Bear.Liab.	92.30	92.21	92.42	92.48	92.46	92.43	92.41

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GAAP INS. FSLIC THRIFTS-IEA/IBL>90%
HISTORICAL & FORECASTED STATEMENTS OF OPERATIONS
(Dollars in Thousands)

	HISTORICAL			FORECASTED			
	1984	1985	1986	1987	1988	1989	1990
Interest Income	$ 2,619,319	$ 2,646,147	$ 2,536,703	$ 2,394,018	$ 2,468,411	$ 2,468,411	$ 2,468,411
Interest Expense	2,465,730	2,348,727	2,137,043	1,961,907	2,004,242	2,004,766	2,005,327
Net Interest Inc. (Exp.)	153,589	297,420	399,660	432,111	464,169	463,645	463,084
Other Operating Income:							
Mortgage Loan Fees	92,251	86,180	99,067	74,568	76,369	76,369	76,369
Loan Servicing Fees	11,184	17,383	20,303	23,880	24,449	24,449	24,449
Other Loan Fees & Charges	19,477	24,081	28,278	25,217	25,842	25,842	25,842
Ser.Chg. & Fees-Trans.Accts.	13,220	18,551	22,435	26,091	26,731	26,731	26,731
Service Corps./Subsidiaries	8,937	16,838	(33,839)	(28,775)	0	0	0
Other	72,772	51,692	35,943	24,954	25,575	25,575	25,575
Total Oth. Operating Inc.	217,841	214,725	172,187	145,935	178,965	178,965	178,965
Operating Expense:							
Officers & Employees Comp.	178,538	197,095	220,111	236,964	242,709	242,709	242,709
Legal Expense	4,933	6,359	8,486	11,462	11,735	11,735	11,735
Office Occ. & Equip. Exp.	86,002	96,086	108,603	116,992	119,843	119,843	119,843
Marketing Expense	25,295	21,162	21,389	22,192	22,730	22,730	22,730
Professional Services	9,375	11,703	12,789	16,232	16,625	16,625	16,625
Amortization of Goodwill	12,242	12,181	11,784	11,717	11,717	11,717	11,717
Other	100,121	146,394	165,459	171,030	175,172	175,172	175,172
Total Operating Expense	416,506	490,980	548,621	586,589	600,532	600,532	600,532
NET OPER. INC. (DEFICIT)	(45,076)	21,165	23,226	(8,543)	42,602	42,078	41,517
Non-Operating Income:							
Profit on Sales of REO & Oth	12,090	11,608	9,320	12,403	0	0	0
Profit on Sale of Investments	23,503	85,762	126,312	27,656	0	0	0
Profit on Sale of Loans	7,313	41,884	95,765	49,229	0	0	0
Amortized Deferred Gains	1,128	1,612	2,271	1,160	0	0	0
Other	33,246	29,555	26,862	17,640	0	0	0
Total Non-Operating Inc.	77,280	170,421	260,530	108,088	0	0	0
Non-Operating Expense:							
Prov. for Losses on Assets	N/A	N/A	N/A	256,713	0	0	0
Loss on Sale of REO & Other	14,105	21,993	36,998	21,152	0	0	0
Loss on Sale of Investments	12,427	15,767	12,999	24,323	0	0	0
Loss on Sale of Loans	18,989	50,790	78,751	16,065	0	0	0
Amortized Deferred Losses	26,172	39,082	46,550	49,899	49,899	49,899	49,899
Other	13,431	19,427	23,136	46,382	0	0	0
Total Non-Operating Exp.	85,124	147,059	198,434	414,534	49,899	49,899	49,899
INC.(LOSS) BEF. TAXES & ADJ.	(52,920)	44,527	85,322	(314,989)	(7,297)	(7,821)	(8,382)
Income Taxes (Credits)	1,936	6,715	26,052	0	0	0	0
NET INCOME (LOSS) BEF. ADJ.	(54,862)	37,769	59,255	(314,989)	(7,297)	(7,821)	(8,382)
Prior Period Adjustments	(7,716)	(19,596)	(21,722)	0	0	0	0
ADJUSTED NET INCOME (LOSS)	$ (62,577)	$ 18,173	$ 37,536	$ (314,989)	$ (7,297)	$ (7,821)	$ (8,382)

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GAAP INS. FSLIC THRIFTS-IEA/IBL>90%
HISTORICAL & FORECASTED FINANCIAL RATIOS - BALANCE SHEETS
(As a Percent of Total Assets)

	HISTORICAL			FORECASTED			
	1984	1985	1986	1987	1988	1989	1990
ASSETS							
Earning Assets	88.61	88.52	88.64	90.22	90.22	90.22	90.22
Non-Earning Assets	11.39	11.48	11.36	9.78	9.78	9.78	9.78
TOTAL ASSETS	100.00	100.00	100.00	100.00	100.00	100.00	100.00
LIABILITIES							
Interest Bearing Liab.	96.00	96.00	95.90	97.55	97.58	97.60	97.63
Non-Interest Bearing Liab.	1.59	1.55	1.59	1.61	1.61	1.61	1.61
TOTAL LIABILITIES	97.59	97.56	97.49	99.16	99.19	99.21	99.24
REGULATORY CAPITAL							
Preferred Stock	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Perm. Stock & Cont. Cap.	0.07	0.09	0.08	0.08	0.08	0.08	0.08
Qualif. Subordinated Deb.	0.01	0.01	0.01	0.01	0.01	0.01	0.01
Appraised Equity Capital	0.33	0.34	0.35	0.33	0.33	0.33	0.33
Net Worth & Income Cap. Cert.	0.30	0.31	0.35	0.33	0.33	0.33	0.33
Retained Earnings (Deficit)	1.70	1.69	1.71	0.08	0.06	0.03	0.00
Dividends Paid	0.00	0.00	0.00	0.00	0.00	0.00	0.00
TOTAL REGULATORY CAPITAL	2.41	2.44	2.51	0.84	0.81	0.79	0.76
TOTAL LIABS. & REG. CAP.	100.00	100.00	100.00	100.00	100.00	100.00	100.00

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GAAP INS. FSLIC THRIFTS-IEA/IBL>90%
HISTORICAL & FORECASTED FINANCIAL RATIOS - STATEMENTS OF OPERATIONS
(As a Percent of Average Assets)

	HISTORICAL			FORECASTED			
	1984	1985	1986	1987	1988	1989	1990
Interest Income	10.17	9.69	9.09	8.27	8.33	8.33	8.33
Interest Expense	9.57	8.60	7.66	6.78	6.76	6.76	6.77
Net Interest Inc. (Exp.)	0.60	1.09	1.43	1.49	1.57	1.56	1.56
Other Operating Income:							
Mortgage Loan Fees	0.36	0.32	0.35	0.26	0.26	0.26	0.26
Loan Servicing Fees	0.04	0.06	0.07	0.08	0.08	0.08	0.08
Other Loan Fees & Charges	0.08	0.09	0.10	0.09	0.09	0.09	0.09
Ser.Chg. & Fees-Trans.Accts.	0.05	0.07	0.08	0.09	0.09	0.09	0.09
Service Corp. /Subsidiaries	0.03	0.06	(0.12)	(0.10)	0.00	0.00	0.00
Other	0.28	0.19	0.13	0.09	0.09	0.09	0.09
Total Oth. Operating Inc.	0.85	0.79	0.62	0.50	0.60	0.60	0.60
Operating Expense:							
Officers & Employees Comp.	0.69	0.72	0.79	0.82	0.82	0.82	0.82
Legal Expense	0.02	0.02	0.03	0.04	0.04	0.04	0.04
Office Occ. & Equip. Exp.	0.33	0.35	0.39	0.40	0.40	0.40	0.40
Marketing Expense	0.10	0.08	0.08	0.08	0.08	0.08	0.08
Professional Services	0.04	0.04	0.05	0.06	0.06	0.06	0.06
Amortization of Goodwill	0.05	0.04	0.04	0.04	0.04	0.04	0.04
Other	0.39	0.54	0.59	0.59	0.59	0.59	0.59
Total Operating Expense	1.62	1.80	1.97	2.03	2.03	2.03	2.03
NET OPER. INC. (DEFICIT)	(0.18)	0.08	0.08	(0.03)	0.14	0.14	0.14
Non-Operating Income:							
Profit on Sales of REO & Oth	0.05	0.04	0.03	0.04	0.00	0.00	0.00
Profit on Sale of Investments	0.09	0.31	0.45	0.10	0.00	0.00	0.00
Profit on Sale of Loans	0.03	0.15	0.34	0.17	0.00	0.00	0.00
Amortized Deferred Gains	0.00	0.01	0.01	0.00	0.00	0.00	0.00
Other	0.13	0.11	0.10	0.06	0.00	0.00	0.00
Total Non-Operating Inc.	0.30	0.62	0.93	0.37	0.00	0.00	0.00
Non-Operating Expense:							
Prov. for Losses on Assets	N/A	N/A	N/A	0.89	0.00	0.00	0.00
Loss on Sale of REO & Other	0.05	0.08	0.13	0.07	0.00	0.00	0.00
Loss on Sale of Investments	0.05	0.06	0.05	0.08	0.00	0.00	0.00
Loss on Sale of Loans	0.07	0.19	0.28	0.06	0.00	0.00	0.00
Amortized Deferred Losses	0.10	0.14	0.17	0.17	0.17	0.17	0.17
Other	0.05	0.07	0.08	0.16	0.00	0.00	0.00
Total Non-Operating Exp.	0.33	0.54	0.71	1.43	0.17	0.17	0.17
INC.(LOSS) BEF. TAXES & ADJ.	(0.21)	0.16	0.31	(1.09)	(0.02)	(0.03)	(0.03)
Income Taxes (Credits)	0.01	0.02	0.09	0.00	0.00	0.00	0.00
NET INCOME (LOSS) BEFORE ADJ.	(0.21)	0.14	0.21	(1.09)	(0.02)	(0.03)	(0.03)
Prior Period Adjustments	(0.03)	(0.07)	(0.08)	0.00	0.00	0.00	0.00
ADJUSTED NET INCOME (LOSS)	(0.24)	0.07	0.13	(1.09)	(0.02)	(0.03)	(0.03)

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GAAP INS. FSLIC THRIFTS-IEA/IBL>90%
FORECAST ASSUMPTIONS
(Dollars in Thousands)

Page 5

		1987	1988	1989	1990
Total Annual Liability Growth		6.7350%	0.0000%	0.0000%	0.0000%
Chg. In Non-Earning Assets	$	0	0	0	0
Chg. In Preferred Stock Issues	$	0	0	0	0
Dividend Rate	F	0.0000%	0.0000%	0.0000%	0.0000%
Pay Yearly-1,Pass-2,Accrue-3		1	1	1	1
Repay. Preferred Stock Issues	$	0	0	0	0
Permanent Stock Infusions	$	0	0	0	0
New Subordinated Debt Issues	$	0	0	0	
Repay. of Subordinated Debt	$	0	0	0	0
Accrual Rate - Each Issue	F	0.0000%	0.0000%	0.0000%	0.0000%
Appraised Equity Capital Adj.	$	0	0	0	0
N.W. & Inc. Capital Certifs.	$	0	0	0	0
Repay. NW. & Inc. Cap. Cert.	$	0	0	0	0
Interest Rate - Each Issue	F	0.0000%	0.0000%	0.0000%	0.0000%
Non-Cash Capital Infusion	$	0	0	0	0
Dividends Paid	$	0	0	0	0
Retained Earnings Adjustment	$	0	0	0	0
Yield on Exist. Earning Assets		9.2323%	9.2323%	9.2323%	9.2323%
Cost of Funds/Current Liabs.		6.9319%	6.9319%	6.9319%	6.9319%
SPREAD		2.3004%	2.3004%	2.3004%	2.3004%
Yield on New Earning Assets	F	9.5000%	9.2323%	9.2323%	9.2323%
Cost of Funds/New Liabilities		7.0000%	6.9319%	6.9319%	6.9319%
SPREAD		2.5000%	2.3004%	2.3004%	2.3004%
Mtg. Loan Fee/Avg. Assets		0.2577%	0.2577%	0.2577%	0.2577%
Mtg. Loans/Int.Earn.Assets		0.0000%	0.0000%	0.0000%	0.0000%
Yrs. Portfolio Amortization	#	8	8	8	N/A
Avg. Orig. Fee on New Loans		1.0000%	1.0000%	1.0000%	1.0000%
Loan Serv. Fees/Avg. Assets		0.0825%	0.0825%	0.0825%	0.0825%
Mtg. Loans Serv. for Others	$	7,539,078	7,539,078	7,539,078	7,539,078
Avg. Servicing Fee Income		0.0000%	0.0000%	0.0000%	0.0000%
Oth. Loan Fees/Avg. Assets		0.0872%	0.0872%	0.0872%	0.0872%
Fee Inc.-Trans.Ac./Avg. Assets		0.0902%	0.0902%	0.0902%	0.0902%
Trans. Ac./Int. Bear. Liabs.		5.2654%	5.2654%	5.2654%	5.2654%
Transaction Account Fees		0.0000%	0.0000%	0.0000%	0.0000%
Inc. (Loss) - Serv.Corps./Subs.	$	0	0	0	0
Other Operating Inc./Avg. Assets		0.0863%	0.0863%	0.0863%	0.0863%
Off. & Emp. Comp./Avg. Assets		0.8190%	0.8190%	0.8190%	0.8190%
Legal Expense/Avg. Assets		0.0396%	0.0396%	0.0396%	0.0396%
Office Occ.& Equip./Avg.Assets		0.4044%	0.4044%	0.4044%	0.4044%
Marketing Exp./Avg. Assets		0.0767%	0.0767%	0.0767%	0.0767%
Profess. Serv./Avg. Assets		0.0561%	0.0561%	0.0561%	0.0561%
Amortization of Goodwill	$	0	11,717	11,717	11,717
Oth. Oper. Exp./Avg. Assets		0.5911%	0.5911%	0.5911%	0.5911%
Profit on Sales of REO & Oth.	$	0	0	0	0
Profit on Sales of Investments	$	0	0	0	0
Profit on Sales of Loans	$	0	0	0	0
Amortized Deferred Gain	$	0	0	0	0
Other Non-Operating Income	$	0	0	0	0
Provision for Loss - Cash	$	0	0	0	0
Provision for Loss - Non-Cash	$	0	0	0	0
Loss on Sales of REO & Other	$	0	0	0	0
Loss on Sales of Investments	$	0	0	0	0
Loss on Sales of Loans	$	0	0	0	0
Amortized Deferred Loss	$	0	49,899	49,899	49,899
Other Non-Operating Expense	$	0	0	0	0
Income Tax %		0.0000%	0.0000%	0.0000%	0.0000%

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The **Chairman**. Thank you very much, Mr. Ferguson.

Our next witness is Mr. Burt Ely, president of Ely and Company.

Senator **Chafee**. Mr. Chairman, might I submit a statement at this time?

The **Chairman**. Yes, indeed. Your statement will be printed in full in the record.

[Committee insert of Senator Chafee's opening statement:]

SPEECH BY
SENATOR JOHN H. CHAFEE
TO
SENATE BANKING COMMITTEE
ON FSLIC
(MAY 18, 1988)

MR. CHAIRMAN. I WELCOME THE HEARING TODAY ON THE HEALTH OF THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION (FSLIC) AND THE THRIFT INDUSTRY IN GENERAL.

THE THRIFT INDUSTRY WAS INITIALLY CHARTERED TO OFFER A REPOSITORY FOR SAVINGS WHICH COULD BE FUNNELLED INTO RESIDENTIAL MORTGAGE LENDING. THIS APPROACH SERVES THE NATION WELL, WHEN THE GOAL OF EVERY FAMILY IS TO OWN ITS OWN HOME.

CHANGES IN THE LAST 15 YEARS HAVE ALTERED THE FINANCIAL LANDSCAPE FOR THESE INSTITUTIONS, NOT ONLY AS TO INTEREST-RATE RISK BUT AS TO THE DIRECTION OF THEIR FOCUS.

INTEREST RATE RISK

THE THRIFT INDUSTRY TRADITIONALLY PROVIDED LONG-TERM MORTGAGE CREDIT AT FIXED RATES WHICH WERE FUNDED WITH SHORT-TERM DEPOSITS. AS LONG AS INFLATION WAS STABLE, AND A NORMAL YIELD CURVE EXISTED (LONG-TERM RATES ABOVE SHORT-TERM RATES), THIS WOULD BE SUCCESSFUL. UNFORTUNATELY, MUCH HIGHER INFLATION DROVE SHORT-TERM INTEREST RATES ABOVE LONG-TERM RATES. THIS BROUGHT ABOUT THE UNATTRACTIVE prospect of funding the long-term fixed rate mortgages with higher cost short-term deposits. The result was usually an operating loss. Efforts to resolve this problem have been threefold.

First, interest rates that thrifts could offer for deposits were set free from rate ceilings to become market driven. This reduced the previous disintermediation out of thrifts to higher paying alternatives.

Second, thrift institutions increasingly adopted adjustible rate mortgages (ARM). This allowed them to better match the cost of funds (deposits) and revenue from their loans (mortgages).

Third, the growth of securitization meant that thrift institutions would no longer have to keep many of the loans on their books, but be able to sell them into the secondary market. This also freed them to make further mortgages for a set amount of original lending power, creating attractive fee income from origination and servicing of those loans.

The interest rate mismatch became largely containable.

Shifted Focus

There was also a search to broaden the earning base of thrifts into other lending areas. This was partly a response to avoid being completely tied to the mortgage industry, but it also reflected the decision by many thrifts that rates of return in certain areas like commercial lending or real estate development were higher and could be effectively taken advantage of.

Accordingly, the focus of thrift activity has increasingly shifted toward non-mortgage activity.

For a sizable number of thrifts the interest-rate mismatch problem became in short order an asset quality problem. It threatened the viability of many institutions. Some of the problem was doubtless caused by regional recession; another portion by imprudent lending practices that may have bordered on fraud. Additionally, regulatory supervision may well have been lacking in the necessary rigor.

These developments have caused FSLIC to face a tremendous financial strain. The GAO will testify that FSLIC's liability for losses on unresolved claims as of year-end 1987 exceeded $17 billion. This would be to resolve more than 200 GAAP-insolvent thrifts and others expected in 1988 for which FSLIC has assumed responsibility. And this does not cover all the remaining GAAP-insolvent insitutions as of year-end 1987. Some estimates put the eventual total cost at more than $60 billion.

But before we decide on the merits of any specific action regarding FSLIC, it would be well to consider four issues.

First, do thrifts still serve a particular purpose? In return for mortgage lending, thrifts receive long-term, low-rate advances from Federal Home Loan Banks for any use, broad activity choice (such as insurance and real estate), beneficial tax treatment, and wide geographic expansion authority. Yet it is difficult to tell whether the basic thrust of thrifts is to remain principally

MORTGAGE LENDERS OR TO MOVE TOWARD FULL PURPOSE FINANCIAL SERVICES, OF WHICH MORTGAGE LENDING IS ONLY A PART. IS THE AGE OF THRIFTS OVER?

A SECOND ISSUE IS THE NEED FOR INCREASINGLY COORDINATED REGULATION IN THE FINANCIAL SERVICES INDUSTRY. JUST AS THE BRADY COMMISSION HAS SPOKEN OF A SINGLE MARKET FOR EQUITY AND EQUITY-DERIVATIVE PRODUCTS, SO THE DEPOSIT TAKING AND MORTGAGE LENDING MARKETS HAVE MULTIPLE PROVIDERS BUT A SINGLE GOAL.

THE THIRD QUESTION DEALS WITH THE MIXTURE OF COMMERCE AND THRIFT LENDING. IT DOES LITTLE GOOD TO KEEP THE STRUCTURE IN THE RECENTLY SENATE-PASSED PROXMIRE FINANCIAL MODERNIZATION ACT OF 1988 IF WE ALLOW THRIFTS TO EFFECTIVELY COME UNDER THE CONTROL OF COMMERCIAL PARTIES.

A FINAL CONCERN IS THE MAINTENANCE OF SAFETY AND SOUNDNESS. IN THE PROXMIRE BILL, WE RESPONDED TO THIS THROUGH THE CREATION OF A SEPARATE SECURITIES AFFILIATE, ADDITIONAL FIREWALL PROTECTION, AND GREATER REGULATORY SUPERVISION. WE MUST BE CAREFUL IN THIS REGARD ABOUT THE CURRENT ALLOWED ACTIVITIES OF THRIFTS.

IT IS IN THE CONTEXT OF THESE ISSUES THAT WE SHOULD REVIEW THE PERFORMANCE AND FUTURE PROSPECTS OF FSLIC. WHETHER THE $10 BILLION (NET) OF RECAPITALIZATION BONDS TO BE ISSUED WILL BE SUFFICIENT, HOW QUICKLY TO CLOSE PROBLEM THRIFTS, HOW TO REDUCE THE DEPOSIT PREMIUM THAT INSOLVENT THRIFTS ARE PAYING AND CAUSING OTHER DEPOSITORY INSTITUTIONS TO PAY, WHAT TO DO ABOUT FADA--ALL OF THESE QUESTIONS MUST BE DEALT WITH. BUT WE SHOULD FIRST DECIDE THE

OVERARCHING APPROACH AND THEN SEE HOW FSLIC FITS OR DOES NOT FIT INTO THAT STRUCTURE.

I LOOK FORWARD TO THE TESTIMONY OF THE WITNESSES.

Mr. Ely, go ahead, sir.

STATEMENT OF BERT ELY, PRESIDENT, ELY AND COMPANY, ALEXANDRIA, VA

Mr. ELY. Mr. Chairman, I will just summarize my written testimony.

THE THRIFT INDUSTRY AND THE FSLIC PROBLEM

Based on December 31, 1987 data, I have identified 849 thrifts that were hopelessly insolvent on that date. These thrifts had total assets at RAP book value of $398 billion. At the end of 1987, they had a total negative RAP net worth of $5 billion and a total negative GAAP net worth of $10.8 billion.

More importantly, each of these thrifts had a negative net worth of 2 percent or less, after realistically valuing their assets and their going forward earning power.

Collectively, these thrifts had a realistic negative net worth at the end of 1987 of $64 billion. This is the loss FSLIC would have incurred at that time to sell or liquidate these institutions.

In addition, there were another 398 thrifts at the end of 1987 with total RAP assets of $238 billion that had realistically valued net worths ranging from minus 2 percent to plus 2 percent of assets. This is the deteriorating middle tier of the thrift industry.

FSLIC's accumulative insolvency loss is growing rapidly. I estimate that this loss is compounding at the rate of at least 15 percent annually before taking into account the money spent by FSLIC closing or selling failed thrifts. Four factors contribute to this compounding.

First, insolvent thrifts pay interest on the deposits funding their negative net worth.

Second, overhead costs are incurred in raising these deposits.

Third, there are excessive operating costs in some of these insolvent thrifts.

Finally, the assets of many of these insolvent thrifts continue to deteriorate.

I estimate that a 1-percent annual deterioration rate on the $339 billion market value I assign to the assets of these insolvent thrifts would equal about $3.4 billion a year and add about 6 percent to the compounding rate.

LESS VISIBLE PROBLEMS

What I have just presented is only the most obvious part of the thrift problem. There also are related issues that bear mightily on the future health of the thrift industry.

First, thrift net interest margins are declining. The situation for FSLIC thrifts is worse than for the commercial banks. Worse, the thrifts' net interest margin declined 15 percent from the second to the fourth quarters of 1987, while the spread between the median and the average cost of funds widened from 3 basis points in the first quarter to 37 basis points in the fourth quarter of 1987. This indicates the extent to which cost of funds disparities are developing within the thrift industry.

The industry also is sensitive to minor interest rate swings because it is still heavily exposed to fixed rate mortgages. As of last December 31, thrifts held $150 billion of fixed rate mortgages funded with deposits and borrowings with an original maturity of less than 1 year. This means many thrifts are still trying to make money on the slope of the yield curve. However, if the yield curve flattens as it rises, then the net interest margin for many thrifts will be squeezed by those rising rates and a flatter yield curve.

Second, overintermediation appears to be weakening all depository institutions. I am addressing this concept today because it offers important insights into both the causes and the resolution of the FSLIC crisis.

Overintermediation occurs when excess deposits flow through the Nation's depository institutions. That is, various economic forces act to pull more deposits into depository institutions than would be the case under more normal circumstances.

Overintermediation is part of the broader and more widely recognized problem of overbanking.

Overintermediation causes three specific problems which plague all depository institutions, and not just the failing ones.

First, it lowers net interest rate margins from both sides of the equation. Competition to attract or retain deposits drives up the interest rates paid on these deposits. This, in turn, pulls in deposits that otherwise would be invested through other intermediation channels.

This resulting excess of lendable funds then leads banks and thrifts to lend at lower interest rates as they scramble harder to lend out their deposits.

Second, excess lendable funds leads to looser lending standards as these excess funds chase relatively scarce lending opportunities.

Finally, these forces lead to lower profit margins that make it difficult to attract new capital to the banking and thrift industries.

Overintermediation is occurring today because Federal deposit insurance has distorted the pricing of both deposits and loans. Because risky institutions do not pay enough for their Federal deposit insurance, they can bid up deposit rates and still generate what appears to be an adequate net interest margin.

Exhibits 1 and 2 to my testimony illustrate the depository overintermediation that has developed in recent years. Exhibit 1 shows the ratio of total domestic deposits of American-domiciled depository institutions to current dollar GNP for the years 1963 to 1987. Since 1981, deposits have risen to record levels relative to GNP.

Exhibit 2 shows the ratio of total deposit liabilities to our Nation's tangible assets. Here, deposits also have risen.

Based on this and other data, I estimate that American depository institutions currently hold excess deposits in the range of $100 to $150 billion.

Overintermediation also is pushing up the operating costs of our depository institutions. Exhibit 3 shows how depository operating costs, as a percentage of GNP, have risen steadily over the last 25 years, and again most sharply since 1981. These costs exclude interest expense and loan losses. They are merely the brick and mortar and operating costs of these institutions.

Exhibit 2 shows how depository operating costs, as a percentage of hard assets, rose 52 percent from 1981 to 1986. Based on this analysis, I estimate that excess depository operating costs currently range from $2 to $4 billion annually.

The overintermediation phenomenon has contributed to the declining productivity of the financial services sector of the economy.

Exhibit 4 shows changes in deposit market share by type of depository. It illustrates quite effectively how money market funds, which have far lower operating costs than more traditional depositories, have gained market share since the late 1970's.

Savings and loans have experienced a sharp upswing in deposits in recent months while commercial bank and credit union deposits have been relatively flat. This is a cause for concern as it is adding to the overintermediation already present in our economy.

Overintermediation also may be distorting monetary policy management. The rapid growth in the deposits/GNP ratio corresponds with the much-discussed decline in money velocity in recent years.

CAUSES OF THE CURRENT DIFFICULTIES

The root causes of the present difficulties lie in numerous public policy failures over the years. The interaction of these policies has created a greenhouse effect in which fraud, greed, and mismanagement have been able to flourish. Put another way, the extensive criminality and gross mismanagement within the thrift industry is a natural and predictable consequence of those public policy failings and not the root cause. I do not wish to excuse this behavior; I am merely explaining why it has occurred.

Appendix A to my testimony discusses five sets of public policy failings in detail. I will briefly describe them here.

First, an inherently flawed and actuarially unsound Federal deposit insurance mechanism has been the root cause of FSLIC's insolvency. Little wonder that FSLIC suffers large losses when the drunk drivers of the thrift pay the same price for their deposit insurance as do their sober brethren.

Two, Federal inaction has allowed FSLIC's accumulated insolvency losses to grow at an ever faster rate. Had Congress and the administration moved aggressively at any time during the 1980's to quickly close realistically insolvent thrifts, the worst would have been behind us, and at a much lower cost. Instead, these insolvency losses continue to compound in the private sector at a very high rate of interest. Thus, the bulk of the $64 billion accumulated insolvency loss is due solely to Federal inaction.

Three, longstanding intra- and interstate branching restrictions have prevented individual depository institutions from diversifying their lending risks across broad regions of the entire country.

Four, numerous regulatory and monetary policy failures over the years have greatly exacerbated FSLIC's past and present losses.

Five, other Federal policies also worsened the economic environment for both banks and thrifts by leading investors and entrepreneurs to make economically unsound decisions.

With regard to the first root cause, namely Federal deposit insurance, it is important to understand how expensive it has become for our economy in recent years. Exhibits 5 and 6 compare reported

Federal deposit fund losses for the 1978 to 1986 period with losses suffered by depositors in failed banks and thrifts between 1922 and 1933.

As you can quickly note, reported losses in 1984 and 1985 equalled the highest levels reached at any time during the 1920's. The 1986 loss reached depression era levels, and 1987's reported loss will not be so much lower. If FSLIC had properly accounted for its accumulated losses, the 1978-86 line would be even higher than it was.

I will close by commenting briefly on the future. I think that the cleanup job for FSLIC involves two things—cash and talent. This cash needs to be spent fast to sell, merge or liquidate the insolvent thrifts as their accumulated losses are compounding at prohibitive high interest rates.

This process will cause deposit runoffs in liquidated or shrunken thrifts that will in turn reduce the amount of overintermediation in our economy. This deposit shrinkage will pay dividends in permitting sounder depositories with lower operating costs.

Preventing another FSLIC crisis also should become a major congressional and administrative objective.

Clearly, past regulatory philosophies cannot be relied upon to prevent future deposit insurance crises. It is simply beyond the control of the political process to do this.

Thus, Congress needs to begin developing an entirely different approach to the regulation of the financial services sector of the economy. This approach must rely to a much greater extent on pricing mechanisms to control unwarranted risk-taking. In particular, the depositor protection mechanism must be made actuarially sound. In my opinion, this cannot be done within the context of traditional regulatory processes.

Thank you and I welcome your questions.

[The complete prepared statement of Mr. Ely follows:]

TESTIMONY BY BERT ELY

to the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

of the

UNITED STATES SENATE

on the subject of the

OVERALL CONDITION OF THE THRIFT INDUSTRY

May 19, 1988

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THE OVERALL CONDITION OF THE THRIFT INDUSTRY

by Bert Ely

SUMMARY

The overall condition of the thrift industry is not good. Even though many thrifts are profitable and well-capitalized, the industry is steadily being dragged down by an increasing number of insolvent and unprofitable thrifts. These insolvencies in turn have made the Federal Savings and Loan Insurance Corporation (FSLIC) insolvent. FSLIC faces prospective losses, which I estimate reached $64 billion at the end of 1987, that far exceed its foreseeable resources. FSLIC's accumulated insolvency loss is growing at the rate of at least 15% annually before taking into account the monies spent selling or liquidating insolvent thrifts.

The thrift industry also faces less obvious problems. Net interest margins are declining as the general level of interest rates creeps upward and as the "Southwest" premium becomes more widespread. This is a serious problem because thrifts still are very interest rate sensitive. Overintermediation appears to be hurting all depository institutions, including thrifts. This excess flow of funds into depository institutions is further squeezing net interest margins. It also may be creating future loan loss problems.

The declining condition of the thrift industry has largely been caused by the interaction of numerous public policy failings. The two most notable failings are the inherently flawed and actuarially unsound federal deposit insurance system and federal inaction that has allowed FSLIC's accumulated insolvency loss to balloon almost unabated in the private sector.

Several steps have been taken to try to contain the FSLIC problem. The FSLIC Recapitalization Plan, however, has been doomed from the start. Its resources fall far short of the sums needed to clean up the FSLIC mess. The practice of forbearance and delay also has been counterproductive. It simply is not possible for most insolvent thrifts to earn their way back to solvency. This testimony outlines six reasons why forbearance is ultimately an exercise in futility. The same can be said of the "Southwest Plan." Like its parent Recap Plan, the Southwest Plan promises only a fraction of the resources that are needed to dispose of insolvent Texas thrifts. This plan also has set an unrealistically low objective for the amount of equity capital that is needed to restore the Texas thrift industry to good health.

Looking forward, two problems must be dealt with as quickly as possible. One, large amounts of cash and talent must be quickly injected into a FSLIC clean-up program. The present pace is just too slow. And the job cannot be done entirely by the regulators. Extensive private sector talents will be needed, but this does not mean that the Federal Asset Disposition Association (FADA) should be reinvigorated. Two, structural reforms need to be implemented to prevent another deposit insurance bankruptcy. But reregulation is not the answer. Instead, the pricing mechanism must be relied on more, and regulation relied on less, to prevent future financial disasters.

THE THRIFT INDUSTRY AND THE FSLIC PROBLEM

Mr. Chairman and members of the committee, I am testifying today with regard to the overall condition of the thrift industry and the extent to which parts of the industry may be experiencing financial difficulties.

Based December 31, 1987, data, I have identified 849 thrifts that are hopelessly insolvent. These thrifts had total assets, at regulatory (RAP) book values, of $398 billion. At the end of 1987, they also had a total negative RAP net worth of $5.0 billion and total negative net worth, under Generally Accepted Accounting Principles (GAAP), of $10.8 billion. Each of these thrifts had a negative net worth of two percent or less after realistically valuing their assets and their going-forward earning power.

I estimate that collectively these thrifts had a realistic negative net worth at the end of 1987 of $64 billion. This amount equals 16% of their total assets at book value. This is the loss FSLIC would have incurred on that date to sell or liquidate these thrifts. In effect, this is the size of the check FSLIC would have had to write to get someone to take these failed thrifts off its hands. Included in this group of thrifts were 419 thrifts that were neither RAP nor GAAP insolvent because of as-yet-unrecorded losses in asset values. These losses are still buried in their books.

In addition, there were another 398 thrifts at the end of 1987, with total RAP assets of $238 billion, that had realistically valued net worths ranging from -2% to +2% of assets. This is the deteriorating middle tier of the thrift industry. During the second half of 1987, 146 of these thrifts reported net losses. I did not estimate how much FSLIC will lose in this group of thrifts. However, some of them are destined to fail.

This leaves 1,900 thrifts, with total RAP assets of $615 billion that were reasonably healthy at the end of 1987. Together, they had a total GAAP net worth of $37 billion. However, we should not be complacent about these thrifts because they are facing increasing financial pressures due to narrowing net interest margins and the darkening cloud of the insolvent thrifts.

I prepared these estimates by calculating and then averaging two values for each thrift: the market value of its assets and the capitalized value of its gross interest income. This technique improves upon GAAP and tangible net worth data because it estimates losses that have not yet been recorded by the thrift.

To the extent possible, I calibrate my estimates against published Bank Board estimates of FSLIC's loss in recent thrift failures. My loss estimates generally have been lower than FSLIC's own estimate of what its case resolutions so far this year will cost FSLIC.

The market value of a thrift's gross interest income stream often shows a larger potential insolvency loss for that thrift than does the marked-down value of its assets. This occurs in part because the Bank Board does not collect market value data for investment and mortgage-backed securities portfolios of thrifts. It also does not release the data needed to estimate differences between the book and market value of assets caused by interest rate fluctuations. This data is found in Section H of the quarterly financial reports thrifts file with the Bank Board. This non-disclosure greatly hampers the ability to assess FSLIC's future.

FSLIC's accumulated insolvency loss is growing rapidly. I estimate that this loss is compounding at the rate of at least 15 annually before taking into account the monies spent by FSLIC closing or selling failed thrifts. Four factors contribute to this compounding:

1 - Insolvent thrifts pay interest on the deposits funding their realistic negative net worth. For the 849 clearly insolvent thrifts, their cost of funds averaged approximately 7.5% in the second half of 1987.

2 - Overhead costs are incurred in raising the deposits funding the negative net worth. I estimate this annual cost at 1.5% of deposits.

3 - Excessive operating costs exist in these insolvent thrifts due to general operating inefficiencies and the intensity with which their marginal assets must be managed.

4 - The assets of these insolvent thrifts continue to deteriorate. I have conservatively estimated a one percent annual deterioration rate on the $339 billion market value I assigned to the assets of the 849 thrifts insolvent on December 31, 1987. This deterioration has several causes:

- Continuing deflation and price declines on assets owned by the thrift or the collateral backing up its loans.
- Mismanagement of non-performing loans and repossessed properties.
- Fraud and ineptness in making new loans.

At the present time, an increase in the asset deterioration rate from 1% to 2% would raise the annual compounding rate on FSLIC's accumulated loss by 5.4%.

This 15+% "carry cost" compares to December's 5.8% rate on 91-day T-bills and an 8.1% rate on three year Treasury notes. Based on the estimated FSLIC insolvency loss of $64 billion and a 7% cost differential, the additional cost of carrying FSLIC's accumulated insolvency loss in the private sector currently is $4.5 billion annually. As interest rates rise, the rate at which FSLIC's accumulated insolvency loss is compounding also will rise.

LESS VISIBLE PROBLEMS

What I have just presented is only the most obvious part of the thrift problem. There also are related issues that bear mightily on the future health of the thrift industry.

Thrift net interest margins are declining. The situation for FSLIC thrifts is worse than for the commercial banks. Although the net interest margin for the thrift industry in 1987 was $2 billion more than 1986, higher operating expenses chewed up two-thirds of this increase.

Worse, the thrifts' net interest margin declined 15% from the second to the fourth quarters of 1987. Texas accounted for only one-third of this decline. The decline in net interest margin occurred because both the median and the average cost of funds for thrifts bottomed out in the second quarter of 1987 and has been rising ever since. However, the spread between the median and the average cost of funds widened from three basis points in the first quarter of 1987 to 37 basis points in the fourth quarter. This indicates the extent to which cost of funds disparities are developing in the industry.

This growing disparity may be attributable in part to a faster rise in the cost of borrowed funds, compared to deposits, during the second half of 1987. Weaker thrifts generally are more reliant on borrowed funds than stronger thrifts. The recent increase in short-terms rates will keep pushing up the average cost of funds for thrifts.

Thrift profitability still is extremely sensitive to slight changes in interest rates. On a dollar weighted basis, the industry's deposits are subject to being repriced every eight months. That is, the interest rate can be changed every eight months on the average dollar on deposit. From the big picture perspective, the market value of the total assets of FSLIC-insured thrifts drops by over $1 billion for every basis point that the net interest margin declines.

The average time to the next repricing opportunity for thrift deposits actually declined slightly from the first quarter of 1986 to the last quarter of 1987. This indicates that the industry as a whole did not take advantage of last year's interest rate bottom to significantly extend deposit maturities.

The industry is sensitive to minor interest rate swings because it is still heavily exposed to fixed-rate mortgages and mortgage-backed securities. As of last December 31, thrifts held $150 billion of fixed-rate mortgages funded with deposits and borrowings with an original maturity of less than one year. This means many thrifts are still trying to make money on the slope of the yield curve. However, if the yield curve flatten as it rises, then the net interest margin for many thrifts will be squeezed by both rising rates and a flatter yield curve.

Overintermediation appears to be weakening all depository institutions. I am addressing this concept because it offers important insights into both the causes and the resolution of the FSLIC crisis.

What is overintermediation? Overintermediation occurs when excess deposits flow through the nation's depository institutions, be they banks, savings and loans, credit unions, or money market mutual funds. That is, various economic forces act to pull more deposits into depository institutions than would be the case under more normal circumstances. Overintermediation is part of the broader and more widely recognized problem of an excess number of banking organizations and branches.

Overintermediation, like overcapacity in any industry, can have adverse, yet not readily visible, consequences for an entire industry. In the case of federally insured depository institutions, these adverse consequences will cost the taxpayer money if deposit insurance losses cannot be totally funded by the depository institutions.

Overintermediation causes three specific problems which plague all depository institutions, and not just the failing institutions.

> First, it lowers net interest rate margins from both sides of the equation. Competition to attract or retain deposits drives up the interest rates paid on deposits. This, in turn, pulls in deposits that otherwise would be invested elsewhere in the economy.
>
> Driving this competition are the scores of cash flow insolvent thrifts that must bring in new deposits or hang on to existing ones in order to pay their bills. We see this clearly by contrasting the Texas thrifts with the relatively less desperate Texas banks. During 1987, Texas thrifts increased their deposits by 6.1%, or $4.9 billion, and boosted their borrowings by 32%, or $4.7 billion. At the same time, Texas banks reduced their deposits by 8.4%, or $13.8 billion.
>
> This resulting excess of lendable funds then leads banks and thrifts to lend at lower interest rates as they scramble harder to lend out their deposits. These lower rates may be a short-term benefit for borrowers, but the long-term hangover for the economy does not make them worthwhile. The growth in securitization is adding to this problem by reducing lending opportunities for banks and thrifts at a time when lendable funds are increasing.
>
> Second, excess lendable funds lead to looser lending standards as excess funds chase relatively scarce lending opportunities. We may be planting the seeds today that will bring new credit problems to the banking world in the early 1990s. These could be problems in home equity lending, credit card receivables, or leveraged buyout loans, to name a few.

Third, these forces lead to lower profit margins that make it difficult to attract new capital to the banking and thrift industries. This is occurring at a time when both banks and thrifts are under increasing pressure to raise their capital levels. It also could retard much needed banking innovation.

If overintermediation persists, it may have the Gresham's Law effect of driving out the better managed banking capital, due to low profitability, while leaving behind less well-managed and eroding capital resources. Overintermediation also harms the value of marketplace franchises. Thus, we may see an effect comparable to what the strong dollar did to American manufacturers earlier in this decade. This could lead to a permanent loss of domestic market share to foreign-domiciled banking organizations. The recent rapid growth in business lending by foreign banks indicates that this process already is well underway.

Overintermediation is occurring today because federal deposit insurance has distorted the pricing of both deposits and loans. Because risky institutions do not pay enough for their federal deposit insurance, they can bid up deposit rates and still generate what appears to be an adequate net interest margin.

Healthier institutions naturally respond by matching the rates offered by their riskier brethren. They do this to hold on to increasingly important market share. This competition consequently pulls more funds through depository institutions than otherwise would be the case.

Exhibits 1 and 2 illustrate the depository overintermediation that has developed in recent years. Exhibit 1 shows the ratio of total domestic deposits of American-domiciled depository institutions to current dollar GNP for the years 1963 to 1987. It also shows short and medium term interest rates for those same years. One can clearly see the disintermediating impact of the Federal Reserve's Regulation Q in certain years as rising rates pulled down deposits relative to GNP. However, since 1981, deposits have risen to record levels, relative to GNP.

The top line in Exhibit 2 shows the ratio of total deposit liabilities to tangible or hard assets. Hard assets equal the replacement cost, net of depreciation or wear-and-tear, of reproducible public and private sector assets plus the market value of privately-owned land. This represents the value of the tangible assets located in the United States.

Based on this and other data, I estimate that American depository institutions currently hold excess deposits in the range of $100 billion to $150 billion.

Overintermediation is pushing up the operating costs of our depository institutions. Exhibit 3 shows how depository operating costs, as a percentage of GNP, have risen steadily over the last 25 years, and most sharply since 1981. Operating costs are the people, computer and building costs of the banking and thrift industries. They exclude interest expense and loan losses.

In 1986, the operating costs for all depository institutions totaled $116 billion. That figure probably rose to $125 billion in 1987. These figures do not include several billion more spent in the United States by foreign-domiciled banks.

Operating costs also have risen rapidly since 1981 when expressed as a percent of the assets of depository institutions. This great jump in operating costs postdates the rapid increase in bank and thrift branches during the 1960s and 1970s. While some of this increase represents the increased scope of banking activities in the 1980s, the costs associated with overintermediation have contributed to this cost increase.

The lower line in Exhibit 2 shows how depository operating costs, as a percentage of hard assets, rose 52% from 1981 to 1986, going from .503% of hard assets to .763%. Based on this analysis, I estimate that excess depository operating costs currently range from $2 billion to $4 billion annually.

Other liabilities of the financial sector grew even faster in the 1981-86 period than deposits in depository institutions. This suggests that the overhead costs associated with this rapid growth of financial liabilities are becoming an increasing drag on the American economy. The overintermediation phenomenon undoubtedly has contributed to the declining productivity of the financial services sector of the economy since 1973. The Council of Economic Advisors noted this decline in its 1988 report.

Exhibit 4 shows changes in deposit market share by type of depository. It illustrates quite effectively how money market funds, which have far lower operating costs than more traditional depositories, have gained market share since the late 1970s, largely at the expense of the commercial banks. It also shows how savings and loans and savings banks have regained market share since the disintermediation crunch of 1981 and 1982.

Savings and loans in particular have experienced a sharp upswing in deposits in recent months while commercial bank and credit union deposits have been flat. This should be a cause for concern as this is adding to the overintermediation already present in our economy. This data, coupled with narrowing interest rate margins, strongly suggest that overintermediation is relatively greater among FSLIC-insured thrifts.

Overintermediation also may be distorting monetary policy management. The rapid growth in the deposits/GNP ratio corresponds with the much-discussed decline in money velocity in recent years.

CAUSES OF THE CURRENT DIFFICULTIES

The committee has expressed interest in my assessment of the causes of the present difficulties in the thrift industry. The root causes of the present difficulties lie in numerous public policy failures over the years. The interaction of these policies has created a greenhouse effect in which fraud, greed and mismanagement have been able to flourish. Put another way, the extensive criminality and gross mismanagement within the thrift industry is a natural and predictable consequence of these public policy failings and not the root cause. I do not wish to excuse this behavior; I am merely explaining why it has occurred. There is no way the extremes that have occurred would have been tolerated outside this greenhouse.

Appendix A discusses five sets of public policy failings in detail; I will briefly describe them here:

> One, an inherently flawed and actuarially unsound federal deposit insurance mechanism has been the root cause of FSLIC's insolvency. Little wonder, then, that FSLIC, and the FDIC for that matter, suffer large losses when the drunk drivers of the banking and thrift worlds pay the same price for their deposit insurance as do their sober brethren. More fundamentally, the existence of federal deposit insurance reflects a startling inability by the capitalist societies of the world to create a mechanism that imposes all bank and thrift insolvency losses on private sector equity capital.
>
> Two, federal inaction has allowed FSLIC's accumulated insolvency losses to grow at an ever faster rate. Consequently, a substantial portion of FSLIC's accumulated insolvency loss of $64 billion is due solely to federal inaction. Had Congress and the Administration moved aggressively at any time during the 1980s to quickly close realistically insolvent thrifts, the worst would have been behind us, and at a much lower cost. Instead, these insolvency losses continue to compound in the private sector at very high rates of interest. In effect, the government has privatized a not insignificant portion of the national debt.
>
> Three, long-standing intra- and interstate branching restrictions have prevented individual depository institutions from diversifying their lending risks across broad regions or the entire country. Because of these restrictions, large loan losses are being absorbed by FSLIC and FDIC instead of by the stockholders of geographically widespread firms. Geographical risk dispersion still provides one of the most effective ways to protect a depository institution from becoming insolvent.

Four, numerous regulatory and monetary policy failures over the years have greatly exacerbated FSLIC's past and prospective losses. Long-standing federal home financing programs and the Fed's Regulation Q share the blame along with more recent regulatory laxity and ineptness.

Five, other federal policies also worsened the economic environment for both banks and thrifts by leading investors and entrepreneurs to make economically unsound decisions. In particular, specific tax, energy, and agricultural policies led directly to subsequent investment and lending decisions that today are bringing a great deal of grief to both FSLIC and FDIC.

With regard to the first root cause, federal deposit insurance, it is important to understand how expensive it has become for our economy in recent years. Exhibits 5 and 6 compare reported federal deposit fund losses for the 1978 to 1986 period with losses suffered by depositors in failed banks and thrifts between 1922 and 1933. Exhibit 5 relates losses to GNP while Exhibit 6 relates losses to total deposits.

As you will quickly note, reported losses in 1984 and 1985 equalled the highest levels reached at any time during the 1920s. The 1986 loss reached depression era levels, and 1987's reported loss will not be too much lower, assuming the 1987 addition to FSLIC's "estimated contingent liability" approximates what has been rumored. The enormous losses in 1986 and 1987 occurred largely because of FSLIC's addition to its estimated contingent liability, or reserve for future losses. The reported losses in 1986 were four and one-half times the amount of deposit insurance premiums collected by the federal deposit insurers. If FSLIC and FDIC properly accounted for their known future losses, the 1978-86 line in these exhibits would be much higher.

What is particularly disturbing is that these losses are occurring under much more favorable economic conditions than we experienced during the Great Depression. Unlike the losses of the early 1930s, which reflected almost entirely the price deflation of that era, today's losses to a great extent reflect a real waste of economic resources. We see this in the vast overbuilding of real estate that occurred after the disinflationary forces of the early 1980s were unleashed. We also see this in the unnecessary operating costs incurred by the entire banking system as a result of overintermediation.

Although federal deposit insurance ended the randomness with which depositors suffered losses, this equity has been achieved at a large and unnecessary cost to our economy. Thus, any effective and permanent resolution of the FSLIC problem must encompass a fundamental restructuring of the depositor protection mechanism. This restructuring must seek to lower the waste of real economic resources we have experienced in recent years while protecting both depositors and taxpayers from private sector insolvency losses. Resolving the FSLIC situation without confronting its causes will be both tragic and an enormous waste of effort and future economic resources.

PAST EFFORTS TO DEAL WITH FSLIC

I will now address what has been done so far to clean up the FSLIC mess.

The FSLIC Recapitalization Plan, which was incorporated in the Competitive Equality Banking Act of 1987, never had a chance of resolving the FSLIC situation. The funds proposed to be spent under this plan are totally inadequate relative to even the lowest estimates of the size of the FSLIC problem. Furthermore, the plan funds itself largely by mortgaging FSLIC's future premium income. This is extremely short-sighted because it leaves unanswered the question of how future thrift insolvency losses will be paid.

The plan also is predicated on a seldom articulated, but widely held, belief: FSLIC should spend no more than $5 billion annually resolving its problems no matter how fast its losses are growing. If this limited thinking continues, the FSLIC hole will keep getting deeper at a faster and faster rate.

In sum, the Recap Plan is nothing more than a delaying tactic. Unfortunately, the delay may not be as long as many supporters of the Recap Plan had hoped.

This leads us to the broad issue of forbearance and delay. Forbearance is founded on the premise that insolvent thrifts can earn their way back to solvency as property values recover. This will not happen.

Forbearance assumes that property values will recover faster than the interest costs incurred while waiting for values to recover. However, forbearance overlooks six important facts.

1 - The "carry cost," or the waiting cost is high. As I estimated above, interest, overhead costs and asset deterioration in insolvent thrifts have pushed the carry cost for insolvent thrifts to at least 15% annually, assuming asset deterioration is held to one percent annually.

2 - Many real estate markets are plagued with too many buildings, or excess capacity. This unused space will remain a drag on real estate values until job growth and expanding population create real demand for this space. This overhang problem is greatly aggravated by the fact that much of this space is held by financially weak owners, including insolvent thrifts, that the market knows cannot hang on until property values recover. Demolition also is helping to reduce this excess capacity, but this will not happen overnight. The Wall Street Journal reported last week that 10,000 housing units were torn down in Houston last year and that another 8,000 may go this year. This demolition dramatically illustrates the real economic waste funded at least in part by wayward banks and thrifts.

Unfortunately, much more demolition is needed, particularly of commercial real estate. Demolition, however, ends any hope of property value recovery for the unfortunates who owned or held a mortgage on the demolished property.

3 - The cost of building today, as versus buying or leasing existing space, is much cheaper than a few years ago. Sharply lower land prices as well as more reasonable development and construction costs have led to this cost decline. Thus, lower current construction costs effectively cap property value recoveries.

4 - Building obsolescence will brake future property value recoveries, particularly where initial construction or ongoing maintenance is not up to par. This problem will accelerate as owners abandon properties that are a continuing cash drain to them. They will not indefinitely "feed" their high vacancy properties.

5 - Inflation will boost carrying costs long before property values recover. Not only is inflation not a panacea for Texas thrifts, but the higher interest rates that would accompany it would be devastating for the rest of the thrift industry and other sectors of the economy.

6 - Much of the property now in default or in thrift inventories is marginal at best or just plain junk. Even in the best of circumstances, many thrifts will not recover what they have sunk into these properties.

In light of these factors, only a few thrifts, at best, will earn their way out of their insolvencies. Instead, the high cost of forbearance could easily spread to the entire financial system.

The so-called "Southwest Plan," which the Bank Board has been touting for months, also is doomed to failure. The plan is totally inadequate because it anticipates spending only one-fourth of the $30 billion needed to dispose of the insolvent thrifts in Texas.

The plan also is premised on consolidating the Texas thrift industry solely within Texas. The Southwest Plan pointedly does not envision the acquisition of any Texas thrifts by large, well-capitalized banking or thrift organizations headquartered outside of Texas. While this plan properly envisions consolidating thrift organizations and branch offices, I have found no mention of shrinking the deposits of the Texas thrift industry by the $15-$20 billion of excess deposits in these thrifts. Most of this shrinkage will have to be funded with FSLIC cash since there is insufficient liquidity in the Texas thrifts that should be shrunk or liquidated.

It is completely unrealistic to attempt to recapitalize the Texas thrift industry on the basis of its existing negative net worth plus the investments of individual investors. The Texas thrifts which I have determined are solvent had a positive GAAP net worth of $565 million at the end of 1987. Even if Texas thrift liabilities were shrunk $20 billion, to $88 billion, and even if FSLIC covered all of the thrift insolvency losses in that state, investors would have to infuse the remaining Texas thrifts with $2.2 billion of new equity capital just to bring the Texas industry up to a three percent GAAP net worth.

Given the problems First City Bancorporation had in raising $500 million of equity capital, it will be extremely difficult for anyone to raise this amount of equity under even the most favorable circumstances while maintaining the independence of these thrifts. The importance of geographical risk dispersion further mandates that a substantial portion of Texas' thrift assets be acquired by financial institutions operating regionally or nationally.

LOOKING TO THE FUTURE

Finally, the committee has requested comments on the ability of state and federal regulators to deal with the thrift industry's problems. There really are two parts to this issue: cleaning up past problems and preventing future problems.

This clean-up job will require two things -- cash and talent. I estimate that it would have taken $64 billion to clean up the FSLIC mess as of the end of 1987. That cost probably has risen $3 billion since then.

This cash needs to be spent fast to sell, merge, or liquidate the insolvent thrifts whose accumulated losses are compounding at prohibitively high interest rates. This process will cause deposit runoffs in liquidated or shrunken thrifts that will, in turn, reduce the amount of overintermediation in our economy. This deposit shrinkage will pay dividends for our economy in the form of sounder depositories with lower interest costs.

Substantial talent will have to be drawn from the private sector to accelerate this clean-up process since there is insufficient regulatory talent to do the job quickly. Regulators should be limited largely to overseeing this clean-up process rather than doing the work themselves. I do not propose revitalizing FADA or creating another comparable monopoly. Instead, as much work as possible should be contracted to the private sector on an openly competitive basis. The investment and commercial banking and real estate industries are logical places to look for this help.

The thrift problem should be viewed as a national crisis in which money should be spent quickly to avoid even bigger losses in the future. Expanding the regulatory bureaucracy to handle this job would greatly delay this clean-up and add billions to its eventual cost.

Preventing another FSLIC crisis should become a major Congressional and Administration objective. Unlike the Ohio and Maryland thrift crises in 1985, FSLIC's problems cannot be shifted to another level of government. The Ohio and Maryland thrift insurers were mini-FSLICs and their crises forerunners of FSLIC's present crisis.

Clearly, past regulatory philosophies cannot be relied on to prevent future deposit insurance crises. For reasons beyond the control of the political process, we are rapidly approaching the practical limits of the efficacy of the regulatory process as we have known it. Technology and America's financial deficit with the rest of the world are destroying the homogeneity, isolation, and slow rate of change on which all regulatory schemes are necessarily premised. Instead, fast-paced technology is rapidly breaking down industry barriers and permitting diversity among regulatees that taxes the regulatory process beyond its realistic limits.

The reimposition of Regulation Q, for instance, would merely hasten the decline of our depository institutions, wasting substantial resources along the way, while not preventing interest rate competition. That clock cannot be turned back.

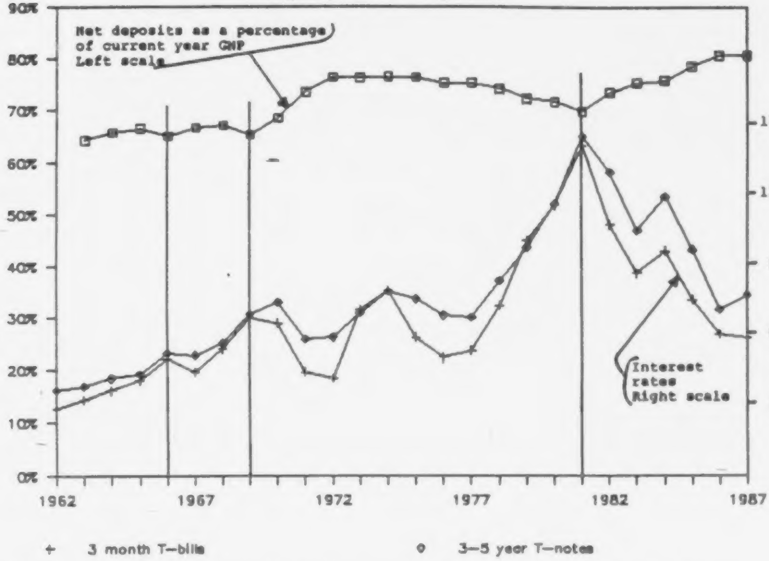
Thus, as our nation approaches the next millennium, Congress needs to begin developing an entirely different approach to the regulation of the financial services sector of the economy. This approach must rely to a much greater extent on the pricing mechanism to control unwarranted risk-taking. In particular, the depositor protection mechanism must be made actuarially sound. In my opinion, this cannot be achieved within the context of traditional regulatory processes.

Thank you.

Exhibit 1

Deposit Levels and Interest Rates

Average Deposits to Average Rates

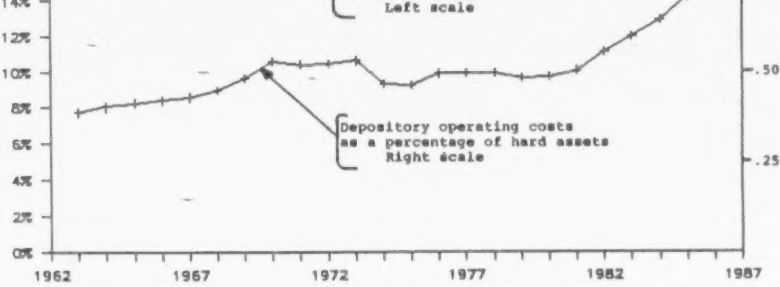


Net deposits = Deposits in commercial banks (domestic deposits only), savings banks, savings and loans, credit unions and money market funds, net of deposits in other domestic depository institutions.

Exhibit 2

Deposit Liabilities to Hard Assets

& Depository Operating Cost/Hard Assets



"Hard" Assets = Replacement cost (less accumulated depreciation) of reproducible public and private sector assets plus market value of privately owned land.

Deposit Liabilities = Deposits in commercial banks (domestic deposits only), savings banks, savings and loans, credit unions, and money market funds, less deposits in other domestic depository institutions.

Exhibit 3

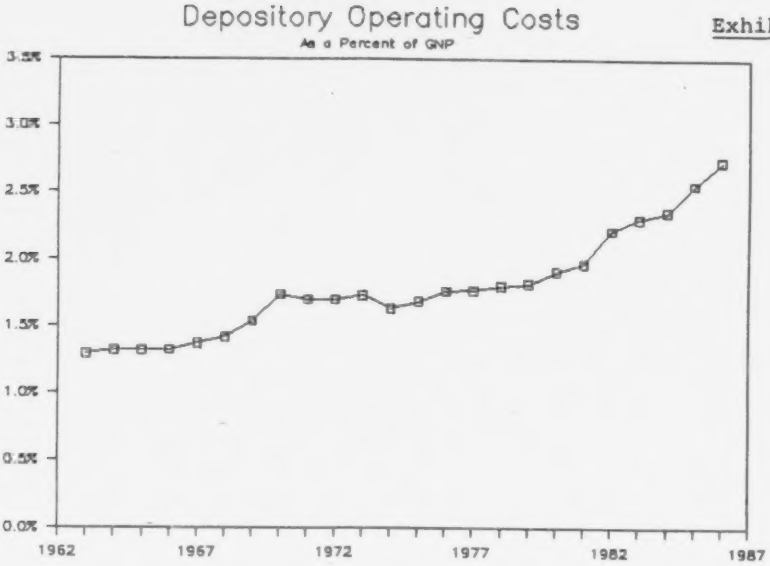


Exhibit 4

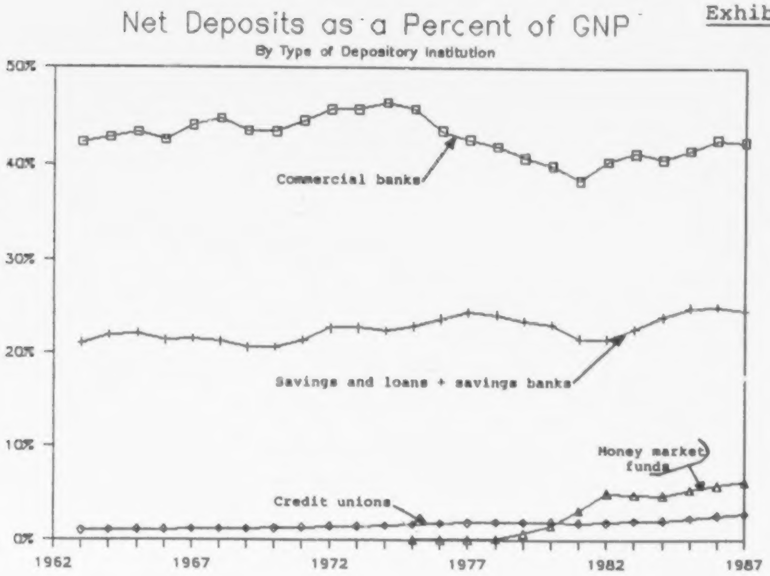


Exhibit 5

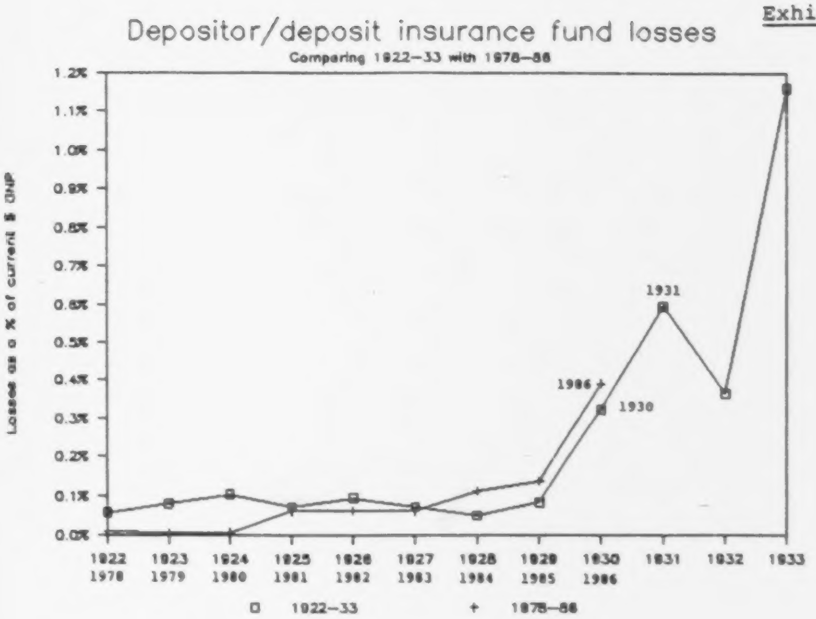
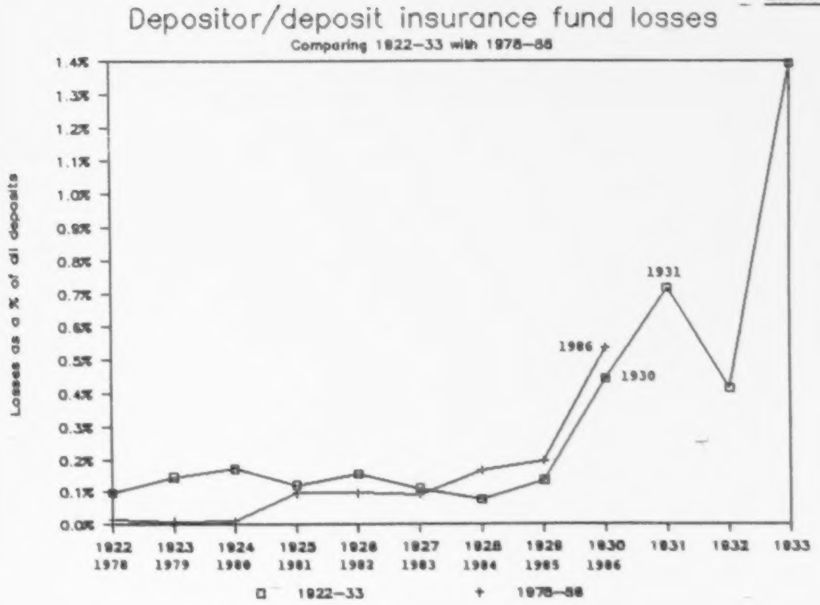


Exhibit 6



Appendix A

FIVE SETS OF PUBLIC POLICIES THAT HAVE MATERIALLY CONTRIBUTED TO FSLIC'S BANKRUPTCY

1 - An inherently flawed deposit insurance mechanism has been the root cause of FSLIC's accumulated insolvency losses. Federal deposit insurance is not a true insurance mechanism because it lacks risk-sensitive pricing. Its flat-rate premium actually encourages unwarranted risk-taking by both depository institutions and regulators by not discouraging unwarranted risk-taking.

2 - Federal inaction has allowed FSLIC's deficit to grow at an increasingly faster rate. As a result, this portion of the federal deficit, i.e. FSLIC's accumulated insolvency loss, continues to be "parked" off the federal balance sheet in insolvent thrifts. Unfortunately, this off-balance sheet portion of the federal debt carries a much higher interest rate than the cost of federal debt directly issued by the U. S. Treasury.

There are three components to this cost of "parking" FSLIC's accumulated insolvency loss. The first is the cost of the deposits funding the $64 billion loss. The rate on these deposits is approximately 7.5%. The second component is the operating cost of running the deposit-taking and asset management activities related to the accumulated insolvency loss. This is estimated to add at least 1.5% to the carrying cost of this insolvency loss. The third cost component, and the hardest to quantify, is the cost of inefficient operations and asset mismanagement in the thrifts that are doomed to fail. These thrifts have assets with a total book value of $398 billion. Assuming this deterioration cost annually equals just 1% of $335 billion in assets (at market value), then this cost currently adds 5.5% to the carrying cost of the accumulated insolvency cost. This brings the annual interest rate on these "parked" losses to approximately 15%.

3 - Long-standing branching and interstate banking restrictions have prevented individual depository institutions from diversifying their lending risks across broad regions or the entire country. Had regional or interstate branching been in place by 1980, the loan losses arising out of the regional and sectorial deflation of recent years would have been borne by individual institutions out of profits they earned on a nationwide basis. However, because of branching restrictions, these deflationary losses have bankrupted hundreds of thrifts operating within the affected regions. FSLIC in turn has had to absorb these losses.

4 - Numerous regulatory and monetary failures over many years:

- During the post-war years particularly, federal housing policies exacerbated the inherently unsound borrow-short, lend-long financial structure of thrifts by encouraging and assisting thrifts in making long-term, fixed-rate loans.

- The extension of the Federal Reserve's Regulation Q interest rate controls to thrifts in 1966 breathed new life into the thrift financial structure by attempting to control the cost of funds for thrifts. However, this act fostered the continued growth of thrifts. Between the end of 1966 and the end of 1979, the assets of federally insured thrifts (S&Ls and mutual savings banks) almost quadrupled, rising from $182.1 billion to $715.2 billion. Thrift assets actually grew faster than GNP, rising from 23.6% of GNP at the end of 1966 to 28.5% of GNP thirteen years later.

- The Fed changed the interest rate ground rules in October 1979 when it stopped controlling interest rates. The subsequent explosion in rates, which reflected the inflation then raging in the economy, drove the entire thrift industry into insolvency on a market-value basis. Operating losses in 1981 and 1982 dropped the book value of thrift net worth from 5.7% of assets at the end of 1979 to 3.4% at the end of 1982.

- The deregulation of thrifts in the aftermath of the Fed's 1979 change in interest rate policies was badly bungled. The cost of thrift liabilities was deregulated much more rapidly and extensively than thrift asset powers. Furthermore, the examination and supervision of FSLIC-insured thrifts were not expanded to cope with the greater risk-taking powers granted to thrifts and the increasing heterogeneity of this industry.

- Regulators have used very liberal accounting principles and illusory capital to mask the extent to which the solvency of the thrift industry has declined. This cover-up has greatly exacerbated FSLIC's losses.

5 - Specific federal policies over the years have harmed depository institutions far more than they have harmed other, less-leveraged institutions:

- Accelerated tax depreciation in the early and mid-1980s led to overbuilding of commercial real estate and subsequent losses where real estate values later declined. Lenders have been major losers. More specifically, accelerated depreciation increased the cash flow generated by new commercial real estate and thus stimulated construction of new buildings by increasing the number of projects that appeared to be financially feasible. That factor, coupled with a rapid appreciation of real estate values driven by the high inflation of the early 1980s, led to lending standards that in hindsight were imprudent.

- Various federal and state petroleum pricing and production policies accentuated the inflationary consequences of the Arab oil boycotts and production cutbacks of the 1970s. The subsequent drop in oil prices was a major cause of the deflationary pressures that have crunched the extractive industries and the real estate activities associated with them. In other words, had various public policies not accentuated the run-up in the price of oil and all of the expansionary activities encouraged by that high price, neither the subsequent price decline nor the consequences of that decline would have been so hard on both banks and thrifts.

- Farm price support programs and subsidized exports unjustifiably inflated land values in the 1970s. When that bubble burst, farm bankruptcies soared and scores of banks and thrifts subsequently failed.

The CHAIRMAN. Thank you very much, Mr. Ely.

Our next witness is Mr. Stanley Silverberg. As I said, Mr. Silverberg is a former University of Wisconsin undergraduate and he's gone on to become the Director of Research of FDIC and now is associated with the Golembe Associates. Go right ahead, sir.

STATEMENT OF STANLEY C. SILVERBERG, SPECIAL CONSULTANT, GOLEMBE ASSOCIATES, WASHINGTON, DC

Mr. SILVERBERG. Mr. Chairman, I've been asked to discuss the condition of the thrift industry and FSLIC, the extent of existing problems, how the problems came about, and whether regulators have financial resources to deal with the problems.

These issues, along with alternative approaches for resolving the problem, are discussed in a report I wrote last month for Golembe Associates and I've submitted that for the record along with some very brief comments that I will cover today.

I hope the members of the committee and their staffs will read the longer written submission which is an attempt to provide a starting point for addressing what I consider to be a very substantial problem.

Last year, one-third of FSLIC-insured S&L's experienced losses which amounted to more than $13 billion. A substantial number of S&L's are insolvent based on RAP accounting. A considerably larger number have negative tangible net worth.

If we aggregate those institutions that are virtually certain to fail or require assistance, take into account their reported negative net worth, and FSLIC's cost experience and likely future cost experience in disposing of failing S&L's, we very easily get to a figure in the $50 billion range.

Arguments could be advanced for lowering that figure or raising it. Ultimately, the costs will be affected by delay which will increase the cost even on a present value basis, interest rate developments, real estate markets, and failure management policy. Nevertheless, I believe we can believe we can be confident that the cost of handling failing S&L's will be several times the resources that will be available to FSLIC under existing law.

FSLIC RECAPITALIZATION

The FSLIC recap program enacted by Congress last summer established a financial corporation that may borrow $10.8 billion, making the funds available to FSLIC. However, a large share of FSLIC's future assessment income will be committed to pay interest on that borrowing. The only real contribution to FSLIC's net worth from the recap program came from a contribution of up to $3 billion from the Federal Home Loan Banks. The extent of the current insolvency today of FSLIC I believe is much closer to $50 billion than the $15 or $17 billion numbers that have been suggested elsewhere.

Now just because FSLIC is insolvent and doesn't have the resources to solve most of its problems doesn't mean that it has to close up shop, at least for now, or stop assisting the acquisition of failing S&L's. There are several ways that FSLIC has been economizing on cash in assistance transactions. These include issuing its own notes or IOU's instead of cash to acquiring institutions or guaranteeing a satisfactory return in the future on nonperforming assets. Both of these features have been used in the last couple of Southwest transactions. These arrangements can defer most of the transactions cash outlays into future years. However, as future commitments increase—including those associated with paying interest on the FICO borrowing—they will eventually overwhelm FSLIC's cash flow. Theoretically, FSLIC could pay interest on its notes and future spread maintenance payments with more notes. However, institutions would have to be willing to take those FSLIC notes. That probably would require a commitment from Congress that it will honor the notes, and, in effect, Congress would be providing an open-ended right to incur Treasury debt.

FSLIC can and has economized on its transactions cost by entering into what I would characterize as "thin" deals with institutions and investors acquiring failing S&L's. Why would anybody accept a "thin" deal? Sometimes it's done by allowing a weak institution to acquire a failing one, thereby prolonging, though not assuring, the survival of the weak institution. In some instances, FSLIC and the Bank Board have enhanced limited tangible assistance by providing substantial capital forbearance and/or waiving growth restrictions for an acquiring institution or investor group. This allows the acquiror to operate with enormous leverage, affording investors an opportunity to make a lot of money if in fact there is a turnaround situation. This more than compensates the investors for the high failure risk, especially since most of the risk is being borne by FSLIC. In these "thin" deals FSLIC is able to reduce its costs at the outset. Its risk is increased, and its longer run costs may or may not increase. The forbearance and supervisory exceptions compromise consistent S&L supervision. In addition, a competitive burden is placed on other depository institutions.

Still another alternative is to allow insolvent institutions to continue to remain open. Even where appropriate constraints are placed on the institution's management, this will almost always increase FSLIC's present value cost because of the high funding costs and operating expenses involved in the insolvent institutions. There are additional potential losses associated with asset impairments and loss of franchise value through incompetence, inappropriate incentives and occasional dishonesty. Where management behavior is not closely controlled, FSLIC will be exposed to the substantial risk that is inherent to allowing an insolvent institution to operate.

While the Bank Board might be able to nurse its resources and keep going for, say, 2 more years, there are considerable costs associated with pursuing such a policy. I've already covered some of these, but let me list a few of them and repeat some of the others.

Delay will raise the ultimate cost of disposing of insolvent S&L's and expose FSLIC to increased future risk.

"Thin" deals will also expose FSLIC to increased future risk.

Both practices have pushed up the cost of funds for all S&L's and some banks, including healthy institutions. This, along with competition from undercapitalized S&L's, has put downward pressure on margins of depository institutions and made it very difficult for an adequately capitalized institution to earn a satisfactory return. I believe this has contributed to the recent decline in earnings experienced by most thrifts.

As the size of the hole faced by FSLIC gets larger and more apparent, there is an increased risk that loss of public confidence will substantially increase the cost of funds and push solvent S&L's into insolvency.

The continued operation of so many insolvent institutions and the use of so many supervisory exceptions makes it virtually impossible to implement tough and consistent supervisory policies and enforce capital standards. This hurts healthy institutions and invites a continuation of undisciplined activities within the industry.

While so many insolvent institutions remain alive, it will be extremely difficult to get on with the task of putting the deposit insurance and supervisory system in order.

Mr. Chairman, for the reasons I have cited, it is important that we acknowledge the enormity of the S&L-FSLIC problem and start to develop a program to deal with the problem realistically and address needed regulatory and supervisory changes in order to limit losses and prevent a recurrence of what has happened over the last several years.

Thank you.

GOLEMBE

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THE GOLEMBE REPORTS

Vol. 1988-3

Several years ago (see Vol. 1986-4) I took the banking industry to task for failing to seize the opportunity to insist on merging the FSLIC into the FDIC. Not only was this in the public interest, I argued, but it also would bring an end to a destructive competitive situation for banking. The industry's reaction was something less than enthusiastic -- in fact, downright hostile. But as was predictable, the FSLIC situation has continued to deteriorate, such that the threat of a raid on the FDIC fund has increased while the opportunity to do something constructive has probably diminished.

The FSLIC problem remains to be solved. Dr. Stanley C. Silverberg, formerly Director of Research and Strategic Planning at the FDIC, recently has become a Special Consultant to Golembe Associates and has agreed to serve as guest editor for this issue of our report, and to offer his views on the FSLIC issue. Readers should find these views of special interest, in part because of Dr. Silverberg's background and his reputation as a perceptive commentator on public policy issues, and in part because of the manner in which the relevant questions are identified. Needless to say, I find some comfort in, and agreement with, his concluding observations.

Carter H. Golembe

Memorandum re: The Problems of Savings and Loans and FSLIC

The problems of savings and loan associations (S&Ls) and the Federal Savings and Loan Insurance Corporation (FSLIC) have been receiving increasing attention in the press and public policy forums as it becomes apparent that the FSLIC recap plan passed by Congress last summer will provide only a small fraction of the resources that FSLIC will need to resolve existing S&L problems. New proposals to resolve FSLIC's problems, possibly in conjunction with a FSLIC-FDIC merger, will certainly receive considerable attention in Congress next year. This report provides some historical background on how the problem developed, a discussion of options for dealing with the problem and some of the issues that may have to be faced in developing a solution for the problem.

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I.

RECENT HISTORY

Because of the importance of fixed-rate mortgages in their asset portfolios, S&Ls had always been vulnerable to rising interest rates. However, as long as interest rate fluctuations were moderate, fluctuations in S&L earnings were also moderate. That changed dramatically in the late 1970s when inflationary pressure in the economy boosted interest rates substantially. Treasury bill rates which had averaged about 5.5 percent in 1977, rose to an average of more than 10 percent in 1979, about 11.5 percent in 1980, and peaked at close to 16 percent in 1981. Depository institutions experienced substantial deposit outflows, interest ceilings at banks and thrifts were raised, new deposit instruments were developed, and eventually deposit rate ceilings were eliminated altogether.

As the cost of funds increased at S&Ls interest margins declined sharply, turning negative in 1980 and remaining negative through 1982, and as a result, S&Ls experienced substantial operating losses. Between 1980 and 1983 about 470 FSLIC-insured institutions (about 12 percent of the institutions) were closed or merged to avoid failure. If S&Ls had been required to mark their mortgage portfolios to market in 1982, typical write downs would have exceeded 20 percent, and virtually all S&Ls would have been insolvent. In the aggregate the insolvency would have been about $100 billion.

In order to avoid being overwhelmed by the problems it faced, the Bank Board and Congress attempted to shore up industry earnings and net worth through a variety of devices, including net worth certificates, deferred losses on asset sales and favorable accounting treatment in other areas, including the acquisitions of failing institutions. While these devices did not contribute to "real" earnings or net worth, they bought time and delayed technical insolvencies. This was supposed to allow institutions to stay alive until interest rates declined and/or they could grow out of their problem. Eventually interest rates did decline and many S&Ls became profitable again. In the case of others, however, the unfavorable results of the policies that were pursued more than offset the benefits of lower interest rates. Aggressive growth, sometimes through lending in areas where the institution had limited experience, contributed to massive asset quality problems that began to appear just when interest rate problems no longer seemed so important.

Many S&Ls have been allowed to operate despite an absence of net worth, and until the last few years, there were few constraints placed on their growth. Indeed, the Bank Board reduced net worth requirements to prevent them from constraining S&L growth. For S&Ls that sought to grow out of their problem, higher yielding (generally riskier) assets appeared to offer the best opportunity to turn things around. Unfortunately, many of these institutions did not have the staff to make such loans prudently; some were victimized by dishonest operators inside and outside their institutions; and real estate markets subsequently deteriorated most in precisely those areas where loans could be most readily booked.

Federal legislation enacted in 1982 expanded lending options for federally chartered thrifts. Several states (California and Florida) significantly liberalized powers for state chartered S&Ls. Texas had taken the lead much earlier in opening up what state chartered institutions could do. Surely nobody envisioned how badly those powers would subsequently be used. There has been substantial debate about whether expanded powers are good or bad for S&Ls and whether they materially contributed to the S&L problem. Clearly they did contribute to the problem. However, it is important to put this into perspective. Direct investment powers opened up riskier opportunities to institutions searching for high return and willing to take risks, and many used the powers poorly. A major contribution to the problem, however, was a breakdown in supervision. Capital requirements that were were insufficient to cushion traditional S&L risks were certainly not sufficient to cushion riskier activities. And examination and supervisory policies were not prepared to deal with riskier asset portfolios.

When an institution operates without capital it has substantial incentive to roll the dice in order to try to become solvent. In other sectors of the economy creditors would have long since prevented any expansion. However, where funding comes from insured deposits and secured borrowings, creditors have no reason to exercise any discipline. Given the situation, it was essential that the Bank Board protect itself and FSLIC and close the insolvent institutions or, when that was not possible, impose tough constraints on growth and lending. Because this was not done until recently, what might have been a manageable problem for the Bank Board and FSLIC has increased well beyond their capacity.

We should not overlook the impact of the behavior of high rollers and operating insolvent institutions on competing S&Ls and banks and on the economy as a whole. By bidding aggressively for funds and earning assets, these institutions pushed up the cost of funds and drove down margins for those institutions that sought to price deposits and loans so that they could earn a market return on an appropriate level of capital. Lending by the high rollers also contributed to the over-expansion and the eventual deterioration of real estate markets in the southwest and other parts of the country.

Current S&L Performance

Following the decline in interest rates in 1982, S&L performance improved and, in the aggregate, the industry had modest positive earnings in 1983 and 1984. When rates declined further in 1985, the industry earned about $4 billion, roughly matching the record earnings experienced in 1978 and 1979 (when the industry was half its 1985 size). Earnings declined sharply in 1986 and became negative by the end of the year. Despite a year-to-year decline in the cost of funds for S&Ls, earnings continued to deteriorate in 1987 and, in the aggregate, the industry lost about $7 billion. The recent earnings deterioration has been the result of asset quality problems (in some cases a belated recognition of those problems) which have led to increases in loan losses and a reduction in interest margins resulting from increases in non-performing assets. Hindsight suggests that earnings reported in earlier years were overstated by interest accruals and selected asset sales.

Aggregate S&L data mask considerable dispersion within the industry and can lead to understatement of the problem. Bank Board data indicate that two-thirds of the S&Ls were profitable in 1987 and earned $6.6 billion, whereas the one-third that recorded losses for the year lost $13.4 billion.

II.

COST OF HANDLING FAILING S&Ls

In its 1986 Annual Report the Federal Home Loan Bank Board estimated that 380 institutions would ultimately require assistance, that the cost of providing assistance to "280 currently insolvent institutions" might reach $21 billion and that assistance to another

100 institutions "that currently have little chance of recovery could add another $4 billion to...losses." The $25 billion loss estimate was generally considered to be a minimum by those who followed S&L losses closely. Recent estimates of the cost of assisting, closing or merging insolvent FSLIC-insured S&Ls have centered around a $50 billion figure. Bert Ely, a consultant who has followed S&L performance closely, estimated in October 1987 that the cost would be $48 to $52 billion. His approach was to value assets and calculate net worth of individual S&Ls based on reported interest revenues (public reports don't show non-performing as do bank reports so it is otherwise harder to value S&L assets from these reports). Our own assessment is that Ely's estimates are not overly pessimistic and that they are in line with the private estimates of several other S&L analysts.

Currently there are about about 500 S&Ls with assets in excess of $200 billion reporting negative tangible net worth of about $22 billion significant operating losses for 1987. If we focus only on these institutions and assume they will all fail or require assistance of 25 percent of assets, the cost would be in the $50 billion range. The cost of closing or merging insolvent S&Ls whose problems are principally associated with poor asset quality has been running in excess of 20 percent. In the S&Ls focused upon here we are starting out with a reported net worth deficiency in excess of 10 percent of liabilities so that we should losses well in excess of 20 percent.

Premiums paid for tax benefits and deposits (where they have value) could reduce moderately the cost of handling these failures. However, while these institutions will probably account for most of FSLIC's costs, there are several hundred other S&Ls that are virtually insolvent and could easily add to the cost over the next few years. Some S&L executives and regulators maintain that write-offs have been aggressive and fully reflect realistic values. That remains to be seen. History on troubled depository institutions suggests they and their supervisors are not quick to recognize reality, and that inaccuracies in reporting by failing institutions rarely reflect excessive pessimism.

FSLIC's Finances

When the Treasury originally proposed a $15 billion FSLIC recap program, prevailing estimates of expected FSLIC losses were considerably lower than they were last summer or today. Using a reasonable set of assumptions the plan appeared to have a good chance of working. A financing corporation (FICO) would borrow $15 billion on a long-term basis over a period of several years. Interest payments would come from FSLIC assessments and the debt

would be retired with the proceeds of zero coupon bonds purchased from funds contributed by the Federal Home Loan Banks. The latter (somewhere in the $2-2.5 billion range) represented the only real enhancement of FSLIC resources. While a large share of assessment income would be committed to debt servicing for several years, growth in the assessment base and collections from earlier failures presumably would generate sufficient cash flow to service debt, phase out the special assessment on S&Ls and handle future failures. All this presupposed that $15 billion would be sufficient to handle then-existing problems and that future failures would decline dramatically, perhaps to the pre 1980s level.

The recap program enacted as part of the Competitive Equality Banking Act of 1987 (CEBA) last summer provided for borrowing of $10.8 billion by a newly established Financial Corporation (FICO). However, by that time few who who had closely examined the condition of FSLIC and S&Ls considered the recap program to be more than a temporary mechanism to delay a future, more fundamental solution to FSLIC's financial problem. As noted, current estimates of funds needed to handle failing S&Ls center around $50 billion. Clearly, there is no way that amount or even half that amount can come from borrowing. The system does not have that kind of debt servicing capacity or access to resources (through future assessments, capital contributions or whatever) to come close to meeting future needs. Thus, the system is substantially insolvent and in need of a large capital contribution from outside sources.

Just because FSLIC is insolvent and doesn't have the resources to solve all or a majority of its problems doesn't mean it has to close up shop (at least for now) or stop assisting the acquisition of failing S&Ls. As noted, most everyone assumed the recap bill would not provide sufficient funds to do the job a year ago. The difference between then and now is that the perceived gap in needed funds is much larger. There are several ways that FSLIC has been economizing on cash in assistance transactions: these include giving its own notes or IOUs to acquiring institutions instead of cash and entering into commitments to provide a market return (generally cost of funds plus some spread) on non-performing assets assumed by an acquiring institution. These arrangements can defer most of the cash cost of transactions into future years. However, as future commitments increase (including those from interest on FICO bonds), they will eventually overwhelm FSLIC's cash flow. Theoretically, it would be possible to pay FSLIC note interest and spread maintenance payments with more notes. However, at some point institutions are apt to be uncomfortable taking more notes and their own cash flow needs will require that someone (like the Federal Home Loan Banks) lend or pay cash for them. The marketplace would have to be assured that Congress will ultimately honor these commitments. In effect, Congress would have provided

FSLIC with an open-ended right to issue "Treasury debt," and it is much more likely that Congress would step in and do some other things before that process had gone very far.

Another way that FSLIC can and has economized on cash is to do some very "thin" deals, i.e., provide minimal assistance in connection with the acquisition of failed S&Ls. How do you get investors or institutions to take thin deals? You let them get by with a very small investment or, where dealing with an acquiror that is an existing S&L, you permit a failing institution to be acquired by another whose survival chances are marginal. You provide capital forbearance, permit good will to count as regulatory capital and waive future growth restrictions. Thus, the acquiring institution is permitted to operate with enormous leverage, affording investors a chance to make a lot of money in a turnaround situation, and this more than compensates for the high failure probability. After all, most of the risk is being borne by FSLIC.

Still another alternative is to allow insolvent institutions to continue to function. Almost invariably this will increase the ultimate cost on a present value basis of closing the institution, even if the insolvent institution is well managed. In addition, there are risks inherent to operating insolvent institutions stemming from a distorted risk-reward trade-off faced by managers and shareholders. There is also a potential loss in value associated with asset impairment (neglect, failure to perfect liens, etc.) and diminution of franchise value where any exists. In many instances the Bank system has placed the operation of an insolvent S&L in the hands of another institution (management consignment program), has been instrumental in otherwise bringing in new management or imposed operating restriction on the institution through supervisory action. These approaches may reduce risks associated with fraud and incompetence, but clearly do not eliminate all the increase in the ultimate cost of dealing with failures or provide the full incentives necessary for effective management.

The Bank Board and FSLIC have been using each of the techniques discussed above. At this point it is not clear how aggressive they will be in effecting transactions and making both cash outlays and future commitments. A serious attempt to negotiate the assisted acquisition of Financial Corporation of America at the end of last year was unsuccessful. That would have involved a considerable financial commitment. The "Texas Plan" has been slow to get off the ground and that reflects, at least in part, the enormity and complexity of the problem. Thus, some of the delay in getting things done probably has not been intentional.

Among S&Ls there are mixed opinions about how fast FSLIC should move. Some are troubled by the continued operation (and growth) of insolvent S&Ls that are bidding for funds and driving down spreads available for stronger institutions. However, some of the same institutions that would like to see the litter cleaned up quickly are fearful of accelerated activity by FSLIC. They are uncomfortable with some of the thin transactions and fearful that a proliferation of FSLIC notes will force them into the Home Loan Banks and impair the S&L investment in the Banks. Many of these stronger institutions await the next step by Congress and would like to see FSLIC merged into the FDIC. Weaker S&Ls are more troubled by the latter prospect. They are fearful of tougher capital standards and, in some cases, of their ultimate survival.

The Bank Board finds its actions more and more subject to criticism from within and outside the industry. The Board is anxious to develop a record of successful, well-constructed transactions to assure its and FSLIC's survival when Congress next addresses FSLIC's financial condition. However, the size of its problems, the limitation on its financial and human resources, growing criticism of its policies by the industry, press and outside analysts, and a record of past mistakes are not conducive to confident and effective policy development.

Costs Associated With Delay

While the Bank Board and FSLIC can probably nurse resources to keep going for two more years, assuming market confidence doesn't collapse, there are considerable costs associated with pursuing such a policy. We have already cited the costs and risks associated with keeping insolvent institutions alive. The "thin" transactions contain substantial risk for FSLIC and may ultimately prove to be very expensive. The regulatory exceptions associated with such transactions distort normal market behavior and are likely to impose costs on competing institutions. They also undermine the development of consistent supervisory behavior, and that can weaken enforcement generally and increase future costs.

The continued operation of insolvent institutions places a significant burden on competing institutions. Funding needs of insolvent S&Ls, many of whom need to grow to pay operating expenses, push up the cost of funds for competing thrifts and banks. Weakened S&Ls that are making loans are not constrained by the need for spreads that are sufficient to provide a market return on "adequate" capital, and this also adversely affects spreads available to healthy institutions. As a result, part of the cost of delay and regulatory exception is borne by healthy depository institutions, including commercial banks, that are forced to meet market and regulatory requirements.

It is virtually impossible to implement even-handed supervisory policy in dealing with everyone else when insolvent and near-insolvent institutions are kept alive. Changes in capital policy and in the deposit insurance system are extremely difficult to implement in an environment dominated by exception, and it will be extremely difficult to implement needed policy changes until much of the litter is cleared off the playing field or at least consistent policy is in place to accelerate that clean-up process.

III.

OPTIONS FOR RESOLVING FSLIC's PROBLEMS

When Congress again addresses FSLIC's financial problems, it will have four basic options: (1) it can let the current situation continue (postpone trying to resolve the problem) by making a modest cash contribution, say $5 billion to FSLIC; (2) it can make a substantial financial commitment to FSLIC, directing it to resolve existing problems as quickly as possible; (3) it can require all S&Ls that have a reasonable survival chance to convert to banks, become insured by the FDIC (under relaxed entry standards), and provide for the liquidation or merging of insolvent institutions; or (4) it can merge FSLIC into the FDIC, presumably in anticipation of closing or merging failing S&Ls as quickly as possible.

The first option is likely to prove to be the most costly in the long run and it will require that Congress come back to the problem within two years. However,the lack of any strong consensus on behalf of the other options may make (1) the most likely initial choice of Congress. Each of the other options will require a substantial up-front financial commitment of taxpayer funds. FSLIC-insured institutions currently pay a special assessment equal to 1/8 of one percent of deposits plus a regular assessment of 1/12 of one percent -- that adds to 5/24 of one percent, about 20.8 basis points compared with 8.3 basis points paid by FDIC-insured commercial and savings banks. The special assessment has generated considerable complaint from healthy S&Ls that would like to acquire FDIC insurance. Under CEBA the special assessment is supposed to be phased out unless the Bank Board requests otherwise because of cash needs. In the long run, of course, the cash is needed. However, the Bank Board has recently submitted a proposal that would phase out the special assessment for those institutions that could afford to pay it (and, incidentally qualify for FDIC insurance).

How much a good institution should be required to pay is an issue on which reasonable people may disagree and there we will not go into the arguments on each side of that issue. Congress will probably want to extract some payments equal to several year's special assessments from S&Ls (under CEBA the exit fees for institutions shifting to FDIC insurance equal about one half of one percent of deposits and that may be a reasonable compromise). In the long run it is doubtful that S&Ls could continue to pay a deposit insurance assessment that is 12.5 basis points higher than what banks pay, and in any case, that would probably cover only a small fraction of the resource needs of FSLIC.

Up to $3 billion of Federal Home Loan Bank resources are committed to purchase zero coupon Treasury bonds to be used to repay FICO borrowings under the recap plan. It probably won't take $3 billion even if the full $10.8 billion is borrowed by the time Congress acts again on FSLIC's problem. Some additional Bank resources could probably be tapped to assist FSLIC. However, the amount of additional Bank funds available would not be very large (perhaps an additional $1 billion over the $3 billion, depending on precise timing) unless Congress were to deplete the capital stock of the Banks (currently about $12 billion). The capital stock is booked as an asset on the balance sheet of thrifts and tapping it would reduce the already low level of thrift capital. It could also adversely affect the operation, including the cost of borrowing of the Banks, and for these other reasons, tapping the capital stock of the Banks is not a good idea.

Another potential source of funds under options (3) and (4) is the FDIC. Its net worth is currently about $18 billion. However, this year's failure rate and unresolved Texas problems suggest that the FDIC's net worth will probably decline in 1988 -- perhaps by as much as $ 2 billion. While the ratio of the FDIC's Deposit Insurance Fund (its net worth) is low by historical standards, more importance has been attributed to that ratio than it deserves. As long as the FDIC has ample resources to deal with current and prospective near-term problems there is nothing special about the ratio of the Deposit Insurance Fund to insured deposits. A Fund of $10 billion or perhaps $7.5 billion may be ample, especially if the FDIC had expanded borrowing rights from the Treasury. Thus, the FDIC might be able to contribute $7 billion to $10 billion to resolving FSLIC's problem and still have resources to function in a satisfactory manner. The FDIC would object to such a contribution, citing its own problems (as Chairman Seidman has done) and reflecting concern that it might get closer to the point where it would have to go to Congress for funds, exposing itself to the appropriations process and Congressional and OMB input into the failure management process.

Institutions insured by the FDIC would object to tapping the FDIC fund. Some consider it to be their's. A more valid concern would relate to maintenance of the current assessment rate. A smaller fund would increase the likelihood of higher future assessments.

Whether Congress finds FDIC resources tempting in order to limit the amount of general revenue that must be diverted to FSLIC, it will not find enough resources within the FDIC to handle more than a modest share of FSLIC's problem. Most of the funding will have to come from general revenues.

If Congress decides to merge the deposit insurance funds or phase out FSLIC, a number of issues that relate to discrepancies between the treatment of banks and thrifts would have to be addressed (failure management policies, supervision, ownership, powers, etc.). Even if Congress commits to the independent survival of the Bank Board and FSLIC some of these same issues would have to be addressed. During most of the remainder of this report, several of these issues are discussed along with how they might be handled under each of the options previously listed. However, before that discussion it would be helpful to consider how we might want a future supervisory and insurance system to function.

IV.

FUTURE DEPOSIT INSURANCE AND SUPERVISORY SYSTEM

The S&L experience in the past decade demonstrates the problems inherent to a system where market discipline is eliminated (through *de facto* 100 percent deposit insurance) and where no meaningful capital standards and operating constraints are applied. If it is not possible to reduce insurance coverage (and it is hard to envision how such a reduction could be implemented for thrifts in the near future), then meaningful solvency and supervisory standards will have to be applied to all depository institutions. Otherwise, the financial position of the insurer will always be threatened and conservatively-run institutions will always be exposed to "predatory competition." With respect to failure management policy, cost should take account of the longer-run implications of what is done so that bigger, more expensive problems are not created for those who come into office in the future. Also, failure management ought to be consistent, the rules and procedures should be disclosed to the public, and, ideally, supervisory and regulatory exception (which transfer costs to operating institutions) should not be put up for sale.

Ideally, the supervisory system would provide consistent rules for all players with respect to ownership, powers and geographic expansion. While safety and soundness and insurance costs are very important, restrictions based on those considerations should not unduly restrict the behavior of those institutions that adhere to solvency and supervisory standards. While trying to keep these overall objectives in mind, let us look at some of the specific issues or areas of conflict that are bound to emerge when Congress seriously looks at solving the FSLIC problem.

A Separate Thrift Industry

The distinction between most banks and most thrifts has been blurred considerably in recent years as a result of expansion in thrift powers and activities. There remain several important regulatory and other differences: deposit insurance; membership in the Federal Home Loan Bank system; asset powers; ownership and holding company rules; taxes; regulation and supervision. The matter of whether a separate thrift industry is maintained, an issue that comes up frequently in discussions about merging the deposit insurance funds, really relates to how a number of separate issues are resolved. Fewer thrifts call themselves savings and loan associations these days and few of these would fight very hard for that right. On the other hand, many thrifts would would be reluctant to give up access to Home Loan Bank borrowing, favored tax treatment or more lenient holding company rules. While logic may argue against treating "a separate thrift industry" as a real issue, trade association officials and others are apt to consider this a very important matter. Substantially strengthening FSLIC (option 2) would preserve a thrift industry. Requiring surviving institutions to apply for FDIC membership (option 3) would threaten the survival of a separate thrift industry, and merging the deposit insurance funds (option 4) would probably leave the issue unresolved, at least at the outset.

It is hard to envision Congress doing away with the thrift industry by forcing S&Ls to become FDIC-insured banks, at least within the next few years. Such legislation, unless it provided special accommodation for thrifts, could also pose significant transition problems in the areas of failure management, the credibility of insurance and supervision. We could envision sufficient modifications such that (3) looks very much like a merger of the insurance funds (option 4). Consequently, it will simplify our subsequent discussion if we focus on two option: preservation of an independent FSLIC (2) and merging FSLIC into the FDIC (4).

Failure Management Policy

The task of disposing of failing S&Ls will continue to be complex and expensive. If FSLIC is dissolved or merged into the FDIC, personnel and other resources within FSLIC would presumably be transferred to the FDIC. While there may be resource gains associated with taking advantage of selective talents or specialized skills, merging by itself won't create resources, and it is not apparent that the FDIC is over-staffed or over-endowed compared with the problems it currently faces. We have suggested the importance of getting on with the task of disposing of failing institutions in a consistent open manner. Further, it is desirable that "solutions" not compromise supervisory policy or impose undue burden on competing institutions. In principle, this could be done by a separate FSLIC. However, that would probably require specific legislative direction, and it would involve a considerable departure from the way things have been done in the past. (While the FDIC's performance has been less than perfect, it has been considerably better than FSLIC's in these areas.)

Part of FSLIC's problem has been the absence of financial resources and the need to conserve net worth and cash. Insolvency has made FSLIC and the Bank Board extremely sensitive to criticism from Congress, the S&L industry and others. This has hampered decision making and independent policy. Money may not eliminate those problems immediately. Moreover, money coming to FSLIC may have more strings and more oversight than money or financial support going to the FDIC in connection with a merger of the funds. Thus, while FSLIC and the Bank Board may do all the right things in the area of failure management under option (2), there are reasons for doubts. In the case of option (4) we might expect to be most comfortable about future handling of failures.

Ownership

Unitary thrift holding companies -- organizations owning one stock S&L or stock savings bank -- are largely immune from the restrictions imposed on the activities of bank holding companies. Most thrift holding companies own only one thrift and fall into this, largely unrestricted, category. Since the Bank Board has permitted S&Ls to branch across state lines the limitation of a single thrift charter has not been an important one for unitary thrift holding companies. Thus, Ford and Sears each currently own an S&L but is not permitted to acquire a commercial bank. If the deposit insurance funds are merged the different treatment of holding companies would have to be resolved. This could be done in several possible ways: (1) S&Ls could become subject to Federal Reserve Board regulation and existing exceptions could either be grandfathered or divestiture could be required; (2) Bank holding company powers could be materially expanded and this would reduce the number of "nonconforming S&L holding companies; or (3) regulation of bank or S&L holding companies could be eliminated altogether except for restrictions on transactions between depository institutions and their parent or affiliates. While the latter alternative makes the most sense, it is unlikely that Congress would be prepared to go this far.

There are two closely related issues related to Federal Reserve policy. If the insurance funds are merged, distinctions between banks and thrifts would diminish or disappear and there would be no rationale (political or otherwise) for restricting the acquisition of healthy thrifts by bank holding companies. Another issue relates to the fact that the Federal Reserve currently regulates capital and leverage of bank holding companies. The Bank Board does not impose capital requirements on thrift holding companies. Here again, Bank Board policy appears to make more sense. However, barring a great surge of insight on Constitution Avenue, existing differences are unlikely to be resolved by eliminating Federal Reserve regulation of the financial structure of bank holding companies.

The holding company differences cited here would not have to be addressed if FSLIC were strengthened (option 2). However, in that case, there would remain an important distinction in the regulation of banks and thrifts that could remain unresolved for some time.

Permissible Activities

Restrictions on what banks and S&Ls can do within their institution are importantly related to what parents can do. Expanding the powers of bank holding companies can allow banking organizations to get into activities that may be risky without exposing the deposit insurer to additional risk. Sometimes that serves to finesse the issue of whether certain activities are too risky to be carried on within the depository institution.

What state chartered banks and thrifts can do with respect to direct and other equity-like investments is determined by state law, and some states have gone very far in these areas. While the FDIC came close to imposing restrictions on direct real estate investments and certain other activities last year, it withdrew proposed restrictions when their implementation appeared to be too cumbersome compared with the potential problems it encountered in a small number of banks, and it chose to deal with those problems on a case-by-case basis. Some S&Ls have considerable flexibility with

The CHAIRMAN. Thank you very much, Mr. Silverberg.

Mr. Greenbaum, we're happy to have you here, from Northwestern University.

STATEMENT OF STUART I. GREENBAUM, STRUNK DISTINGUISHED PROFESSOR OF FINANCIAL INSTITUTIONS, J.L. KELLOGG GRADUATE SCHOOL OF MANAGEMENT, NORTHWESTERN UNIVERSITY

Mr. GREENBAUM. Mr. Chairman, committee members, I appreciate the opportunity to share with you my thoughts on the current state and prospects of the thrift industry.

At the risk of oversimplifying, the problems are two: (1) How do we allocate the enormous losses incurred in recent years that are currently embedded in operating but insolvent or near insolvent thrifts; and (2) how do we remedy the problem of distorted incentives of management of thrifts arising from undercapitalization and the peculiar design of the deposit insurance system?

I'm going to skip over the discussion of background of the problem found in my written statement in the interest of brevity, and if you desire to discuss that later we can, of course.

WHO PAYS?

On the first issue of who pays, there are three obvious oxen that are candidates for goring: the thrifts, the banks, and Mr. and Mrs. America.

The FSLIC recap program is an industry-based answer, but admittedly an inadequate one. It is also onerous in that the associated deposit insurance premia have been more than doubled and are more than double those paid by bank competitors.

The problem has grown too large for the thrift industry to handle. The real issue is what share should the industry be called upon to shoulder? There are two subissues. One is fairness, and here we encounter the delicate question of why should the potentially successful members of the industry be held hostage to the excesses of the minority?

The second is the limited capacity of the solvent members of the industry to sustain added burdens. The paucity of book net worth and the substantial discounts to book in the marketplace for these equities reflect the fragility of the sounder thrifts. Incremental burdens will tip thrifts near the cusp of viability into the abyss. The ability to further tax the industry is probably quite limited.

Proposals to merge FSLIC and FDIC would presumably transfer some of the thrift losses to the banks by weakening the banks' insurance fund. I needn't point out that banks have their own problems, and this could turn out to be a very shortsighted approach.

I would prefer to cleanse the thrift industry of its nonviable members, assess the new structural equilibrium, and then reassess the question of a merger between the funds.

DISTORTED INCENTIVES

Let me turn now to the second major problem—that of distorted incentives. Owner-managers with little of their own capital at stake are managing public assets with an enhanced incentive to choose risky projects. This problem would be substantially mitigated by simply disposing of the failed and almost failed institutions out there now. Hence, there is a danger in overreacting to the general problem.

It seems to be widely believed, however, that even after the workout phase, after we've cleansed the industry of the 500 or 700 nonviable members, a serious incentive problem will remain. This problem is linked to "thin" capital margins and the risk insensitivity of deposit insurance premiums and capital requirements. Again at the risk of oversimplifying, I think we have two general reform options, one being a package of proposals, including mark-to-market accounting, closer supervision, and expeditious closure of failed institutions. In addition, we could add risk-sensitive deposit insurance premia and capital requirements and simply increase capital requirements.

This constitutes one package of reforms. If we adopt mark-to-market accounting, closer supervision and expeditious closure, and we can implement these programs flawlessly, there will be no losses to the Government at all. Hence, there would be no need for the risk-sensitive deposit insurance and the risk-sensitive capital either.

The problem with this package is implementation where the problem turns on being able to value nontraded assets on thrifts' balance sheets and on the will of the regulator to close institutions as they approach insolvency.

Likewise, there are serious questions regarding the implementability of risk-sensitive deposit insurance and risk-sensitive capital requirements owing to problems of measuring risk. These may at first inspection seem like second order considerations, but the problem of measuring risk can subvert any system ostensibly based thereon.

Our forebears had their reasons for choosing the seemingly awkward design we inherited, and I think that those reasons turned on the problem of measuring risk. Most proposals to link deposit insurance to observable performance measures focus on outcomes. These are not ex ante risk measures. You can observe the crash of an automobile, but what you can't observe is whether the driver exercised due care. That may seem trivial but it turns out to be fundamental. With such observability problems it's not clear that risk-sensitive programs will work.

This kind of skepticism has led some to another proposal for reform, a seductively simple one, that you will have to wrestle with at some point, if you haven't already. It's called the narrow bank proposal. The narrow bank has the advantage of separating the depository function of institutions from credit-granting. You simply require insured deposits to be fully collateralized with government securities of like duration, in which case the insuring agency faces no risk, save fraud risk.

This obviates a whole host of complicated measurement and conceptual questions raised by the other reform proposals. Incidentally, this is a proposal that goes back to the 1930's. Henry Simons advocated it. It's been revived in recent years. It's one that commends your attention, along with the alternative proposals that have been offered to correct the incentive problems that we have with these institutions.

Now I want to close on a more optimistic note. I think there is some good news out there, and the good news is reflected in a number of facts. One, we've had hundreds of conversions from mutuals to stockholder ownership among the thrift industry. This indicates that institutions can augment their capital if they have a halfway decent story to tell. I might point out that many have gone to market with less than the most euphoric of prospects and successfully sold stock. I think that's a rather optimistic portent.

Second, I think we can take some comfort in the improvement in the quality of management in the industry and the improvement in the quality of supervision in the industry. The improvement in the supervision is reflected in the growing number, the compensation and the credentials of examiners and supervisors. Most all of the thrift restructurings have been accompanied by improvements in the quality of management. Close observers of the industry are aware of this, these changes are less visible to people outside.

Finally, the recent interest of nonfinancial institutions in committing large amounts of capital to the industry—and here I have in mind the Ford Motor Co., the William Simon group, the Bass Bros., and others—is similarly an optimistic portent. One would have to assume that these are reasonably sophisticated investors and they see some future for thrifts.

I think that there are some hard decisions that you're going to confront in the next year or two, and there is some urgency owing to the incentives problem.

Thank you.

[The complete prepared statement of Mr. Greenbaum follows:]

respect to direct investments and certain service company activities. As previously suggested, these activities have contributed to S&L problems and this, led to Bank Board restrictions on service company activities. If the deposit insurance funds are merged and the FDIC plays a supervisory role with respect to S&Ls, restrictions on direct investments of banks and thrifts are apt to be examined closely. The FDIC might consider subtracting direct or equity investments (or some portion of them) from capital for purposes of measuring capital requirements. S&Ls generally are subject to much less restrictive single borrower limits than are banks, and an insurance fund merger is likely to bring bank standards to S&Ls in this area also.

Supervision and Regulation

Examination and supervision traditionally have been separated within the Home Loan Bank system. Examiners were employees of the Bank Board and follow up supervision was carried on by the Home Loan Banks which frequently had close ties to the institutions they supervised. The overall process placed great stress on detailed rules and regulations. However, there was little focus on credit evaluation and enforcement to prevent or stop unsafe credit practices. In the summer of 1985 the examination function was transferred to the Federal Home Loan Banks (in some of the Banks the distinction between examination and supervision has been largely eliminated). Since then there has been a considerable effort to increase the quality and quantity of examination and supervisory staff. Senior staff were recruited from the federal bank agencies, procedures and training have been revised to increase the importance of credit analysis and supervisory difference between the Bank system and the federal banking agencies have been reduced. Compared with the banking agencies Bank system staff are still relatively inexperienced and, possibly because so many insolvent institutions remain open, policy enforcement is not as vigorous as it might be.

If the insurance funds are merged, examination and supervision of S&Ls probably would have to remain (at least at the outset) with the examination and supervisory staff of the Federal Home Loan Banks. This staff (about 2,100 people) approximates in number the separate supervisory staff of the FDIC or the Comptroller of the Currency. The Home Loan Banks might continue to function as the primary supervisor if the insurance funds are merged, although the FDIC is likely to want to exert considerable input into the supervisory process. Even under option (2), where the Home Loan Bank system survives in tact, supervisory practices will continue to become more like those of the federal banking agencies, although the process may proceed at a slower pace.

At some time in the future a merged deposit insurance fund could result in a relationship between the Bank system and the FDIC that is very much like that which currently exists between the Office of the Comptroller of the Currency and the FDIC. In the latter, the FDIC occasionally engages in joint examinations with the Comptroller in problem banks. However, it generally exerts little direct supervision or control over national banks. The FDIC (and commercial banks) would probably want to see far more control over S&L supervision exercised by the FDIC or bank supervisors generally until relatively uniform supervisory standards are in place.

There are substantial differences in capital requirements and capital levels between banks and S&Ls. Regulatory capital, as defined by the Bank Board includes a substantial amount of good will that would be subtracted from assets and capital under bank regulatory standards. Over time we would expect these differences to be phased out. However, there are apt to be different views on how rapidly that process should proceed and what constraints should be placed on under-capitalized institutions (growth restrictions?) during that phase-in period. While Congress is apt to require future uniformity in capital standards as part of a financial assistance package, which agency presides over the process of reaching uniformity could make a considerable difference. Many S&L officials believe that the Home Loan Bank system would continue to be a more sympathetic regulator and supervisor in the future.

Federal Home Loan Banks

While merging the deposit insurance funds would raise questions about some of the activities of the Federal Home Loan Banks, the necessity of relying on the Banks for S&L supervision would assure their continued operation at the outset. Bank advances to member institutions (which include many FDIC-insured savings banks) currently exceed $130 billion. There is considerable question regarding the need or desirability of these advances, which account for more than nine percent of thrift liabilities. At a minimum, a serious study of the role of the Banks would probably support a substantial reduction in future Bank advances. Some have advocated allowing community banks to borrow from the Home Loan Banks. However, it is difficult to see what public purpose would be served by doing that, and any move in that direction should be preceded by hard analysis of the role and benefits of existing Bank advances. Apart from the impact of advances on resource allocation and mortgage market spreads, there is a significant impact on the deposit insurance system that generally is not appreciated.

Borrowings provide funds for asset growth and an increase in overall leverage. While they do not increase insured deposits, they increase the potential for losses to the deposit insurer without any commensurate payment of insurance premiums. Because Bank advances are fully secured, the assets used as collateral are not available to cover deposits and the deposit insurer in the event of failure. Because only "good" assets may be used to secure Bank advances does not assure that the funds acquired will be used to purchase good assets. Secured borrowing of any kind (Bank advances are the largest single category in the system) is always disadvantages to the deposit insurer, and a close look at deposit insurance in the future would probably support a conclusion that secured borrowing be subject to deposit insurance premiums.

V.

GENERAL COMMENT

In the preceding discussion we have suggested that there are a lot of issues that are closely tied to how the FSLIC and S&L problems are resolved. It will not be easy for Congress to come up with a program that makes sense and also attracts broad support among banks, thrifts, trade associations and regulators. (The latter two groups may pose the greatest problem.) As a result, we could see another temporary program that provides enough Treasury funding to keep FSLIC going for another two years. This would be unfortunate. It would raise the ultimate cost to the public, delay needed changes in the system and impose costs on surviving depository institutions, including banks.

If permanent financing is provided that assures the survival of FSLIC and the Federal Home Loan Bank system, most of the issues discussed in this report would still have to be addressed by Congress. Otherwise, existing inequities and inconsistencies in the treatment of banks and thrifts would be further locked into the system.

Among stronger thrifts there is some support for merging the deposit insurance funds. However, there is little support for such a merger among banks. Their principal and legitimate concerns relate to the implications for higher future insurance assessments and the possibility of being tainted in connection with a substantial public bail out. Arguments on the other side don't seem to be receiving sufficient weight. First, there is the importance of early resolution of the problem so that the predatory competition from insolvent and under-capitalized institutions can be removed. With respect to how the problem is resolved, there may be advantages for banks associated with a merger of the insurance funds. Such a

merger is more likely to lead to uniform capital and supervisory standards that will improve the competitive position of banks. In addition, it may force a hard look at the branching restrictions on banks and on the regulation of the activities and financial structure of bank holding companies. If the "permanent" solution is only a thrift solution, banks may find themselves short-changed in the process.

Stan Silverberg

Stanley C. Silverberg
April 28, 1988

STATEMENT

of

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Before The

Committee on Banking, Housing, and Urban Affairs

U.S. SENATE

May 19, 1988

Mr. Chairman, Committee members, I appreciate the opportunity to share with you my thoughts on the current state and prospects of the thrift industry. Virtually all seem to recognize that sizeable losses reside in still functioning but insolvent, or near-insolvent, thrift institutions. Preoccupation with point estimates of these losses serves as an entertaining distraction with little real purpose. The ultimate cost will depend on numerous decisions that must precede the final resolution of the problem. Twenty-five to fifty billion dollars seems a reasonable estimate, but the cost could go higher if we continue to pursue a dilatory strategy and if interest rates rise or a recession is encountered in the interim. It is even possible that procrastination could reduce the cost, but this seems unlikely.

The dispatch with which we address the problem at hand is linked to the question of "who pays." Delay will worsen the prospects of those institutions that might otherwise survive, and also probably increase the total present value cost of dealing with the problem. The total cost is likely to increase because managers with distorted incentives are permitted to continue to manage public assets. This is the so-called moral hazard problem. If we wish to distill the thrift problem to barest essentials, I believe there are but two issues:

1. how do we allocate the extant losses among potential claimants, and

2. how do we remedy the incentive distortions arising from under-capitalization and the peculiar design of our deposit insurance system?

1. Context

For most of our lives thrifts, and banks too, were protected. Owing to the dislocations arising from bank failures, beginning in 1919 and continuing through the Great Depression, and further owing to the social priority attached to home-ownership, thrifts and banks were accorded deposit-related subsidies. The subsidies grew out of restricted entry, deposit insurance pricing, tax advantages, and ceiling interest rates on deposits. Extraordinary profits resulted and failures were virtually eliminated. As _quid pro quo_, the thrifts and banks accepted governmental supervision and regulation that prohibited various activities and inhibited diversification.

In the case of thrifts, regulatory and legal proscriptions also inhibited the management of interest rate risk, thereby aggravating the debacle of 1980-1 which destroyed a substantial fraction of the industry's capital. The bulwarks of protection, designed to foster stability, gradually eroded in the 1960's and 1970's as periodic interest rate spikes subjected depository institutions to spasms of disintermediation. Technological advances subverted artificial barriers to entry, and tax reforms also hurt. Loan loss reserves became less generous, and more thrifts, particularly mutuals, were subjected to income taxes. Some of the tax increases were probably motivated by a diminished social priority of home-ownership.

In addition, the industry was traumatized by the decade-long inflation of the 1970's. Market interest rates soared opening an unsustainable gap between market and deposit interest rates. Bank customers rebelled, creating money market mutual funds to arbitrage the gaping fissure. The net effect was that thrifts and banks paid increased interest rates as their rate-constrained customers shifted to the mutual funds, which obligingly returned the balances to the banks and thrifts, but in accounts that were not rate-constrained. The episode neatly illustrates the market's adaptability, and the consequent limitations of governmental intrusion. This arbitrage dissipated much of the remaining monopoly rents thrifts and banks earned in the gathering of deposits.

Deposit rents were the franchise. In turn, the economic (not to say accounting) capital of these institutions was little more than the capitalized value of these deposit rents. (For the thrifts, the ability to borrow large sums from the Federal Home Loan Banks also was significant.) This economic capital was a hidden reserve that stabilized the system in two ways. First, it provided a buffer to absorb occasional losses. Perhaps more important, however, was the less direct role of capital in tempering attitudes toward risk taking. In the good old days, thrift and bank owner/managers had more to lose by taking risks. Insolvency would mean the loss of privilege to borrow at substantially subsidized interest rates in perpetuity, or so it seemed. Moreover, it was often feasible to invest the proceeds of deposits in (default) risk-free claims such as duration matched Treasury paper, and still earn a profit. Hence, the so-called "3-6-3 banking" whereby you borrowed at three percent, loaned at six, and were out at the golf course by three in the afternoon.

The protected and subsidized status of these institutions explained the apparently redundant belt and suspenders, the columnar architecture and the virtual absence of failures among thrifts and banks. The dissipation of the deposit rents affected the haberdashery and the architecture, but most especially the asset selection. The thrift industry's asset quality problems, that emerged only subsequent to the bloodbath of 1980-1, are largely explainable in these terms. To be sure, there are anecdotal explanations for the massive credit losses, including energy and commodity prices for example, but these are incomplete, self-serving, and mischievous in deflecting attention from systemic considerations.

2. Who Pays?

Regarding the extant losses, three oxen have been identified as candidates for goring. One is the thrift industry itself. The second is the commercial banking industry, and the last is the taxpayer at large. The FSLIC recapitalization program is an industry-based effort in that the FICO debt is to be serviced with resources from the Home Loan Banks and increased deposit insurance premia. The program is widely recognized to be onerous and inadequate. The $10.8 billion authorized is not nearly enough to resolve the current problem, but the accompanying deposit insurance premia are more than double those previously paid by thrifts and currently paid by commercial bank competitors.

Thrifts by themselves are simply incapable of resolving their industry's problems. Once a mighty monolith, the thrifts have been reduced to a community of 2,000 or so potentially viable institutions and a wretched underclass of [illegible],000 failed or failing institutions. As recently as two or three years ago, the industry was probably formidable enough to resolve its problems internally, but the cumulative deterioration has eliminated that option. The choice today is what share of the cost should the industry be required to assume, and this question will be fought out in these chambers.

In thinking about the allocation of losses, two points are noteworthy. First, thrifts still hold approximately $800 billion in home mortgages, and therefore provide significant intermediation services. Moreover, any major imposition on the industry could result in potentially costly disruptions in the mortgage and related capital markets. It is difficult to say how serious or protracted such dislocations might be, but the solvent and potentially viable segment of the thrift industry is palpably fragile. This is illustrated by book capital paucity and by the substantial discounts to book at which thrift equity trades in the marketplace.

I do not wish to overstate the point. Undoubtedly, the market could reposition the $800 billion in mortgages currently held by thrifts, and public policy should not be shaped for the benefit of thrift stockholders. Rather, the point is that these institutions perform legitimate intermediation services. These services will be performed by existing or newly created institutions. Before jettisoning the old, we should ponder the cost of restructuring. For example, if we seek to saddle the thrift industry with a large part of the cost of failures we may encourage a mortgage finance system built around free-standing mortgage bankers, Freddie Mac, Fannie Mae, Wall Street, insurance companies, pension and mutual funds, and foreign investors. Almost certainly, such a system could support the flow of mortgage finance, but have we really explored the entailments of such a restructuring? The current dispute about competition between Freddie Mac and Fannie Mae, and the thrifts they are alleged to serve, is symptomatic. All are publicly subsidized!

The second point that deserves your attention is the more delicate one of fairness. It goes to the original and evolving intent of deposit insurance. To be sure, if I purchase a fire insurance policy, I expect rising premia if the insurer's loss experience exceeds expectations. But, if the premia become excessive, e.g., if I am pooled with inferior risks, I retain the right to withdraw and self-insure or join a superior pool and thereby qualify for lower rates. In the present case, however, the government is a virtual monopolist, perhaps of necessity. But, exit fees and the paucity of alternatives raise questions of equity that you need to adjudicate. Many will tell you that we no longer need a specialized mortgage lender in this age of securitization. Even if true, this would not justify holding the successful part of the industry hostage for the failures of the dishonest, misguided and unfortunate.

If the successful thrifts are relieved of some of the burden of the failed, then two alternatives remain. One suggestion is merging the FSLIC and FDIC, which would presumably transfer some of the thrift losses to the commercial banks, in the sense that their insurance fund would be weakened. This broadens the base of support and dilutes the amount needed from taxpayers at large. However, the banks are not without their own problems. Even the more modest proposal of shifting the sounder thrifts to the FDIC, and retaining the rest in FSLIC as a workout institution, has serious shortcomings in that thrifts and commercial banks operate under substantially different regulations. The functional convergence of thrifts and banks is probably best achieved gradually, and I doubt that there are great economies to be realized from a merger of the funds. Therefore, it seems advisable to defer the merger decision until the failed institutions have been disposed of and the new structural equilibrium can be assessed.

There is probably a certain immutability about who pays. Friends in the industry explain that a large fraction of the problem is localized in Texas, and if Texas could be surgically excised the remainder could be successfully addressed by the industry itself. Moreover problems in Texas are widely ascribed to the protracted collapse of energy prices compounded by egregious regulatory laxity. I find this interpretation too facile, but not totally without merit. There was an element of *force majeure* to be sure, but the impugned regulatory laxity and asset choices were endogenously influenced by industry participants.

3. *Incentives.*

Thrift capital had been in a secular decline for decades before the bloodbath of 1980-1, and inadequacy was a regulatory concern before that time. However, 1980-1 was a watershed. On some measures, half the industry's remaining capital was lost. Many thrifts had little left to lose. We unwittingly elicited the desperation, recklessness and abandon of the disenfranchised. To be sure, not all thrifts behaved like impecunious gamblers, but enough did to create monumental losses that we now find ourselves trying to allocate.

These incentives still obtain. To be sure, when we dispose of the 500 or so failed or near-failed institutions, the worst of the incentives problem may disappear, but we still will have historically low capital ratios and our capital requirements and deposit insurance premia still will be substantially insensitive to the thrift's chosen degree of exposure.

Most economists seem to agree that the deposit insurance system is in urgent need of basic overhaul. At the risk of over-simplifying, let me outline two alternatives. One seeks to fix the current system with a potpourri of measures including risk-sensitive and perhaps increased capital requirements, risk-sensitive deposit insurance premia, mark-to-market accounting, increased supervision, and more expeditious closure of failing institutions. Indeed, if we flawlessly implemented mark-to-market accounting, continuous supervision (perhaps on-line to a large computer) and a willingness to act promptly, there would be no need for the government to sustain any losses at all. The risk-sensitivity of capital and deposit insurance premia and the enhanced capital would be unnecessary.

Critics of this approach point to the difficulties in implementing mark-to-market accounting among thrifts since many, albeit a declining fraction, of their assets are "untraded." This has led still others to recommend that thrifts be restricted to holding only those assets amenable to continuous valuation, i.e., those traded in active and robust secondary markets. There are additional questions about the cost of continuous monitoring and the regulator's ability to act with dispatch in cases where closure is warranted. But the more fundamental questions relate to risk-sensitive deposit insurance and capital requirements.

The riskiness of a thrift's assets is at best difficult to measure. We can, of course, measure outcomes, but these are *ex post*. What we are after is *ex ante*. That is, we know if the car crashed, but it is often impossible to know if the driver exercised due care. The problem is that bank and thrift assets embody private information not readily observable by outsiders. Often the best we can do is to consult surrogates or proxies, but the car with dual exhausts, oversized tires and rally stripes may belong to an altogether responsible teenager. This not only creates potential inequities, but also can subvert the insurance system. Further discussion of this point is provided in an accompanying working paper entitled "Is Fairly Priced Deposit Insurance Possible?" by Y. S. Chan, S. I. Greenbaum and A. V. Thakor.

Those who despair of measuring risk, or even the value of thrift assets, are drawn to a seductively simple second alternative. Sometimes referred to as the narrow bank proposal, the basic idea is to resolve the incentives problem by eliminating the government's exposure. The proposal calls for securing or "collateralizing" all *insured* deposits with government securities of like duration. The elegance of this alternative is that once implemented almost all other regulatory issues fade into irrelevance. There is no need to measure risk or asset values, apart from the government securities pledged as collateral. Thrifts can lever themselves as much as they wish and hold whatever assets they wish. The narrow bank is not a new idea; it dates at least back to Henry Simons' writings around the time of the Great Depression. But implementing the narrow bank concept would be revolutionary in cleaving a separation between the depository institutions' function of producing liquidity on the one hand, and granting credit on the other.

In a sense, the narrow bank proposal concedes defeat in resolving the moral hazard problems of deposit insurance. Virtually all the risk attendant to deposit insurance, save fraud exposure, would be eliminated. Banks would simply broker government securities to the public, and perhaps provide some minor lot-breaking services. Hence, deposit insurance would be largely redundant. To the extent that thrifts and banks would wish to hold risky assets, these would be financed by *uninsured* liabilities for which they would presumably pay market interest rates. Good-bye subsidies, good-bye governmental exposure, good-bye conflicts, and good-bye moral hazards.

To be sure, there are numerous variants of the aforementioned proposals for deposit insurance overhaul. For example, some suggest simply elevating capital requirements. In the limit, this would eliminate all government exposure, but in intermediate cases, some moral hazards and measurement problems would remain. Others have suggested eliminating deposit insurance entirely on the ground that the need has diminished since risk-free assets are more readily available to "widows and orphans" than was the case even twenty years ago. Mutual funds have neatly filled this void. In any case, fundamental decisions urgently need to be taken in these chambers. I don't reflexively reject muddling through. Procrastination can be constructive, but in the face of moral hazard problems, that's unlikely. Therein lies the urgency, and the reason for the recent assent of cost estimates for fixing the thrift problem.

4. Prospects.

Much of what I have told you may be chilling, and to close on that note would be inappropriate. The thrift industry has come through a nightmarish experience. However, much is salvageable. Let me recount a few facts in support of this more optimistic view. The conversion of hundreds of mutuals to stockholder ownership in recent years indicates that capital is readily available to thrifts. Even institutions with less than euphoric prospects have been able to augment their capital.

I also believe that the quality of thrift management and the quality of governmental supervision have improved in recent years. The latter is reflected in the number, compensation, and credentials of thrift examiners and supervisors. The point about management is more elusive, but the change is unmistakable to close observers of the industry. I'm not asserting that management has improved at all thrifts or even at most, but the improvement in the restructured institutions is clear, and the cleansing effect of egress among failed or merged institutions is equally apparent. I'm confident that the industry is better managed and more closely and professionally supervised than earlier.

The recent willingness of large and well-funded nonfinancial institutions to commit substantial resources to thrifts is likewise optimistic. I'm assuming that the Ford Motor Company, the Bass brothers and the William Simon group, to mention but a few, are reasonably sophisticated investors.

If we provide sounder institutions with an opportunity to survive, many will, but they will evolve away from the model of the traditional thrift. Not all will converge to the same design, no more than all commercial banks will look alike in the future. But most thrifts probably will remain focused on consumer banking and on the mortgage market. Some will gravitate to originating mortgages, others will service mortgages, while still others will securitize various credit instruments. Payments services will remain important and non-mortgage consumer lending will probably grow. Some thrifts will wend their way into business and leasing services. The industry will be less monolithic than in the past, and the population of firms will almost certainly decline. The number of thrifts and banks must shrink for the simple reason that public subsidies, heretofore available to support them, have disappeared and seem unlikely to reappear in the immediate future. Moreover, technology, particularly as it relates to asset securitization, is working to the disfavor of traditional deposit banking. There is no point in decrying the result. We need merely work through the transition with an eye to minimizing attendant costs and avoiding economic distortions that might arise from ill-conceived laws and regulations.

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Preliminary

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IS FAIRLY PRICED DEPOSIT INSURANCE POSSIBLE?

by

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IS FAIRLY PRICED DEPOSIT INSURANCE POSSIBLE?

ABSTRACT

This paper shows that in a deregulated, competitive environment in which depository financial institutions have no access to deposit-linked regulatory subsidies, it may be impossible to implement a risk-sensitive, incentive compatible deposit insurance pricing regime, except in the special case in which the deposit insurer is the sole risk neutral agent in the economy and all other agents are risk averse. This suggests a contradiction between deregulation on the one hand and fairly priced, risk sensitive deposit insurance on the other.

IS FAIRLY PRICED DEPOSIT INSURANCE POSSIBLE?

I. INTRODUCTION

One widely accepted explanation for the recent distress among thrifts and banks lies in the peculiar design of the deposit insurance contract. Many find it inexplicable that financial institutions would be offered a contract with insurance premia largely insensitive to the insured's choices of exposure (see Edwards and Scott (1979), Maisel (1981), Kane (1982) and Marcus and Shaked (1982)). The problems of moral hazard certainly were well known to the system's architects, and there is little reason to believe that our forebears were less perspicacious than contemporary critics.

The extant system distorts incentives and introduces inter-institutional inequities. Thrifts are encouraged to choose risky assets in order to maximize the value of their deposit insurance contract, and high risk institutions pay the same periodic premia per dollar of deposits as their counterparts with more limited exposures, (See Black, Miller and Posner (1978), Buser, Chen and Kane (1981), Merton (1977, 1978), Scott and Mayer (1971), Sharpe (1978) and Taggart and Greenbaum (1978)). The obvious solution to the problem unfortunately encounters implementation problems owing to the unobservability of credit risk. Thrifts' and banks' assets embody private information and, as a practical matter, this precludes conditioning the deposit insurance premium directly on the credit risk of the intermediaries' assets. Clearly, a risk-based premium structure will need to be conditioned on observable surrogates, and this necessitates an oblique approach.

Once this is acknowledged, we confront the problem of selecting an appropriate indicator of exposure. The fair-pricing principle requires that when thrifts and banks are offered the choice of premium/attribute combinations, each, regardless of intrinsic exposure, will optimally select that combination with the premium appropriate for its risk class.[1]

In this paper, we examine the feasibility of using the thrift's (bank's) accounting capital (net worth) as the attribute on which to condition the deposit insurance premium. Accounting capital is readily observable and is thought to be linked to the exposure an institution presents the insurer.[2] The idea is as follows. Suppose there are two banks, one with high-risk and one with low-risk assets, and high-risk assets imply a greater probability of insolvency. Since thrifts forfeit their capital in the insolvent state, it should be more costly for the high-risk thrift to provide capital. Now, if the insurer requires that banks with greater capital be charged a lower deposit insurance premium (intended for the low-risk bank), a truthful self-selection will be effected.

Although this logic is sound, we shall demonstrate a conflict between fair pricing on the one hand, and incentive compatibility on the other.[3] If deposit insurance is fairly priced for both types of banks, all will be indifferent with regard to their capital structure: it will not pay for any thrift or bank to increase its financial leverage if its insurance is correctly priced. However, at these fair prices for insurance, the high-risk thrift will find it profitable to mimic its low-risk counterpart. Given that it is costless to reduce financial leverage, the mimic can appropriate a surplus to itself by posing as a low-risk institution. This incentive to misrepresent will exist unless the insurer requires that the low-risk bank be financed without debt (deposits). In this case, no surplus can be generated from mispriced deposit insurance.[4] But then the issue of deposit insurance vanishes as the low-risk bank becomes a mutual fund.

This negative result has striking implications. First, so long as all thrifts and banks have deposits, an incentive compatible capital-based premium schedule with fair pricing of deposit insurance is a contradiction.[5] Second, to assure truthful revelation of a thrift's or bank's risk, a subsidy of the insured is required and the magnitude of the subsidy increases with the level of deposits at the low-risk banks. On another level, the result casts doubt on the feasibility of providing deposit insurance via the private sector.[6]

The other important problem in the design of an incentive compatible deposit insurance system is the moral hazard associated with asset choice. Apart from proprietary information that thrifts and banks possess ex-ante (unavailable to the insurer), gains are obtained by increasing the riskiness of assets ex-post. With moral hazard, we find that a risk-sensitive deposit insurance system will require multi-period contracting between the institution and the insurer. However, even in a multi-period framework, subsidies can play a crucial role. In fact, in a perfectly competitive credit market, subsidies are indispensible in restoring appropriate asset selection incentives. The intuition is that moral hazard can be controlled only if the insurer credibly threatens punishment in the future for excessive risk taking in the present. Such punitive action should result in either a termination of the charter or a reduction in its value. Subsidies therefore become essential.

The only case in which explicit subsidies may be unnecessary -- in the sense that the deposit insurer can price so as to satisfy a breakeven constraint -- to achieve incentive compatibility is when the deposit insurer is the sole risk neutral agent in an economy in which all others are risk averse. The insurer can then break even while preserving a positive surplus associated with deposits due to the standard risk sharing argument. This will make deposits special relative to thrift or bank equity, and enable the design of an incentive compatible, capital-based deposit insurance system.

Two points are worth emphasizing. First, our analysis is not merely an illustration of the inability of a specially selected regulatory instrument (capital) to provide sorting. Rather, the point is that in a deregulated, competitive environment, an incentive compatible, risk-sensitive deposit insurance system is impossible with any sorting instrument. Thus, our results do not depend on the specific sorting instruments deployed. Second, our results do not depend on the dimensionality of the sorting space, relative to the dimensionality of the attribute space. That is, one may argue that there are more payoff-relevant attributes about which banks have private information than there are observable choices of banks on which the insurer can condition the deposit insurance premium. This problem may preclude having insurance premia that are incentive compatible and also accurately reflect risk. However, in this case a coarse partitioning of banks along the risk dimension might suffice. While this would not provide complete separation, it would nevertheless sensitize the insurance premium to risk. Our point, however, is more fundamental in that even when there are more sorting instruments than there are privately known attributes, separation by risk is impossible in a deregulated environment.

We conclude that the goal of designing a risk sensitive, incentive compatible deposit insurance pricing system may be incompatible with deregulation and a competitive environment, in all cases except one. Without regulatory subsidies, incentive compatibility may be impossible with risk sensitive deposit insurance pricing.

The rest of the paper is organized as follows. Section II describes the

model. Section III examines incentive compatible deposit insurance pricing with private information, whereas moral hazard is considered in Section IV. Section V examines the robustness of our results to model variations. Using alternative objective functions for the bank only strengthens the need for subsidies. Generalizing the model to a continuum of bank types and arbitrary probability distributions for asset payoffs leaves the results unchanged. We also examine the implications of depositor risk aversion. If the private capital market is no less efficient than the governmental insurer in providing insurance, our results are unaffected. Only when the deposit insurer can provide insurance more efficiently than the capital market do we find that incentive compatibility with risk sensitive deposit insurance pricing can be achieved without explicit subsidies. We also examine an alternative mechanism that the deposit insurer can use for coping with informational problems, namely monitoring. Again, subsidies are essential to make monitoring effective. Also in this section, we consider policy implications. We argue that risk sensitive pricing may have been more feasible, if less necessary, in the more regulated environment of the past. Section VI concludes.

II. THE MODEL

Consider a representative bank with access to insured deposits in infinitely elastic supply at the riskless interest rate. For simplicity, the bank is viewed as lending to a single borrower.[7] We take the bank's loan size, I, to be fixed, and the bank chooses the mix of deposits, D, and equity, E, to satisfy the balance sheet constraint, $D + E = I$. All of the formal analysis assumes universal risk neutrality, but alternative preferences are considered in Section V.

The borrower uses the bank loan to finance a single-period project with a two-state probability distribution.[8] The project pays off $R > 0$ with probability (w.p.) θ and zero w.p. $1-\theta$. The payoff, R, in the successful state is observable ex-post by the borrower only. Since all agents are risk neutral, a necessary and sufficient condition for the borrower's project to be socially optimal is

$$\theta R - Ir_f > 0 \qquad (1)$$

where r_f is the riskless interest factor, i.e., one plus the riskless interest rate. Condition (1) is assumed to be satisfied throughout.

Since depositors earn the riskless interest rate on their deposits -- a yield consistent with other competitively priced financial instruments -- the surplus available from the borrower's project will be shared by the intermediary and the borrower. The sharing rule will depend on the competitive structure of the market. If the credit market is perfectly competitive, the standard Bertrand undercutting logic will imply that all of the surplus accrues to the borrower and the bank earns zero expected profit on the loan. On the other hand, if the credit market is monopolistic, all of the project surplus will be appropriated by the bank. With an imperfectly competitive credit market, the surplus is shared.[9] To avoid tying our results to a specific market structure, we shall assume that the bank's objective is to maximize the combined welfare of the borrower and the bank. In Section V alternative market structure assumptions are examined.

Let $p \epsilon (0, 1)$ represent the periodic deposit insurance premium per dollar of deposits. We can either treat p as a constant, as under the current arrangements, or make it a function of some ex-post observable instrument of bank choice. The intuition for linking p to a variable of bank choice is that it may aid the insurer in eliciting private information, and also could help reduce the allocational distortions induced by moral hazard. For simplicity, we abstract from all regulatory restrictions other than capital requirements and deposit insurance.

III. PRIVATE INFORMATION

Suppose two types of banks wherein each lends to one borrower. Bank "H" lends to a borrower with success probability θ_H, and return, R_H, in the successful state. Bank "L" lends to a borrower with success probability θ_L, and return, R_L, in the successful state. Let $\theta_H < \theta_L$, and $R_H > R_L$. Since we wish to focus on the problem of proprietary information, we assume that banks cannot choose their borrowers, but that each knows their borrower's payoff attributes. However, payoff attributes are unknown to the deposit insurer, and to other banks. Thus, the problem is simply one of pre-contract private information. We address moral hazard issues in Section IV.

By assumption, bank H is "high risk" and bank L is "low risk", from the deposit insurer's perspective. We assume that deposit insurance premia are paid at the outset. At the end of the period, if the borrower's project succeeds, the loan is repaid and the bank repays its depositors. If the borrower's project fails, the loan defaults and the deposit insurer repays depositors.[10] Thus, with risk neutrality, if deposit insurance is fairly priced, the periodic premium per dollar of deposits for the high- and low-risk banks will be $p_H = 1 - \theta_H$ and $p_L = 1 - \theta_L$, respectively. Initially, however, we assume that there is a risk-insensitive subsidy associated with deposit insurance That is, $p_H = 1 - \theta_H - \epsilon$ and $p_L = 1 - \theta_L - \epsilon$, where ϵ is a positive scalar For the following analysis, deposit insurance need not be subsidized However some kind of deposit subsidy is required. Such a subsidy might stem from a deposit interest rate ceiling, and/or from monopoly rents owing to restricted entry into banking.

If the deposit insurer is concerned about inequities, it will want to minimize cross-subsidization of riskier by safer banks. One way to address this problem is to link capital requirements to the deposit insurance premia. That is, the deposit insurer can enforce risk-based capital requirements by offering banks a choice between insurance premium and capital requirement pairs, (p_H, E_H) and (p_L, E_L). Each bank can select the pair that maximizes the sum of its own welfare and that of its borrower. The idea is to get each bank to reveal its type through its choice between pairs of capital and the deposit insurance premium.

Now, the expected combined payoff to a bank and its borrower, if the bank is of type i and chooses the pair (p_j, E_j), is

$$\theta_i[R_i - D_j r_f] - E_j r_f - p_j D_j r_f \, . \tag{2}$$

where D_j is determined residually from the budget constraint, given E_j. Incentive compatibility requires that the following non-mimicry constraints be satisfied

$$\begin{aligned} &\theta_H[R_H - D_H r_f] - E_H r_f - p_H D_H r_f \\ &\geq \theta_H[R_H - D_L r_f] - E_L r_f - p_L D_L r_f \end{aligned} \tag{3}$$

and

$$\begin{aligned} &\theta_L[R_L - D_L r_f] - E_L r_f - p_L D_L r_f \\ &\geq \theta_L[R_L - D_H r_f] - E_H r_f - p_H D_H r_f \end{aligned} \tag{4}$$

The regulator's task is to maximize

$$\theta_H[R_H - D_H r_f] - E_H r_f - p_H D_H r_f + \lambda(\theta_L[R_L - D_L r_f] - E_L r_f - p_L D_L r_f),$$

where λ is a scalar "weighting factor", subject to the premium pricing conditions

$$p_i = 1 - \theta_i - \epsilon, \quad i = H, L$$

and the constraints (3) and (4). As is standard in such analyses, the non-mimicry constraint for the type that is jeopardizing its counterpart holds tightly in a Pareto efficient equilibrium. In our case, (3) can be shown to hold tightly. Substituting $p_H = 1 - \theta_H - \epsilon$ and $p_L = 1 - \theta_L - \epsilon$ and treating (3) as an equality yields the following after some rearrangement

$$\epsilon[I - E_H] = [I - E_L][\theta_L - \theta_H + \epsilon] \tag{5}$$

Since $\theta_L > \theta_H$ and $\epsilon > 0$, (5) implies that $E_L > E_H$. Thus, the incentive compatible scheme involves the deposit insurer offering the low-risk bank a lower periodic insurance premium ($p_L < p_H$) per dollar of deposits while imposing a higher capital requirement ($E_L > E_H$). To verify that this necessary condition for incentive compatibility is also sufficient, we should check that (4) is satisfied. Proving that (4) holds reduces to showing that

$$\epsilon D_L \leq D_H [\theta_L - \theta_H + \epsilon] \qquad (6)$$

However, since $D_H > D_L$ and $\theta_L - \theta_H > 0$, (6) holds as a strict inequality.

The intuition is as follows. For a subsidy that is fixed across banks, considerations of fairness will require that the insurance premium be positively related to each bank's risk. However, such a scheme is not incentive compatible since all banks will have an incentive to claim to be low risk. Incentive compatibility can be retrieved, however, by linking capital requirements to the insurance premia. In order to persuade the higher risk bank to truthfully reveal its type, it can be asked to post a lower amount of capital than the low-risk bank. Note that a higher capital requirement is less onerous for a low-risk bank because of its smaller probability of losing its capital.[11]

A quick look at (5) reveals, however, that, if $\epsilon = 0$, (5) can hold only if $E_L = 1$. Thus, without deposit subsidies, the only incentive compatible scheme will require that the low-risk bank fund itself entirely with equity capital. The reason is as follows. Without a deposit-linked subsidy, the bank is indifferent between deposits and capital. Thus, it always prefers an allocation that gives it a lower deposit insurance premium in conjunction with any positive level of deposits. This means that the high-risk bank always covets the allocation of the low-risk bank as long as the low-risk bank has deposits. The only way to eliminate misrepresentation incentives is to eliminate the low-risk bank's insurance premium advantage. But, the only way to remove this advantage is to preclude deposit financing. Hence, subsidies are essential for truthful revelation.

This result refutes the notion that risk-sensitive deposit insurance is compatible with an environment in which banks have no access to subsidies. Of course, one might argue that there is no harm in having some banks funded entirely with capital, although having such banks submit to the regulation and supervision of a deposit insurer is problematic. However, two points are worth noting in this regard. First, with an arbitrarily large number of bank types, i.e., $n > 2$, our analysis implies that without subsidies the only type that is allowed to fund with deposits is the highest risk bank. Second, Kareken (1983) and Niehans (1982), among others, have suggested a solution to the problems of deposit insurance that would eliminate the need for insurance. The deposit contract would be replaced with mutual funds in which investors would hold uninsured equity claims. These funds could provide all of the services currently provided by demand and time deposits with the exception that their value would vary with the underlying assets in the fund. Thus, there would be no deposits and no deposit insurance. Runs would be unlikely since unlike uninsured deposits, the payoff received on an equity contract is not contingent on one's position in the withdrawal queue (see Chari and Jagannathan (1988)). Of course, the mutual fund claim would not be riskless, and this raises the question of the social importance of a pervasively available risk-free claim, albeit at a cost (see Kareken and Wallace (1978)). We cannot settle that issue here. Our more modest objective is to explain that if insured deposits are desirable, then risk-sensitive deposit insurance may be impossible in a setting without subsidies. This would, for example, obviate the competitive provision of deposit insurance.

In addition to private information the deposit insurer must deal with moral hazard. This is the problem we turn to next.

IV. MORAL HAZARD

A. Single Period Model

To focus on moral hazard, we abstract from private information considerations. We now assume that there is only one type of bank, but the bank can choose its assets from a continuum of investment opportunities. Each opportunity is a single-period loan which is used by the borrower to invest in a single period project which returns $R(\theta)$ if successful, and nothing otherwise; θ is the probability of success. Cross-sectionally, $\theta \epsilon [\underline{\theta}, \overline{\theta}] \subset (0, 1)$. We assume $R'(\theta) < 0$. There are two cases: (1) θR is constant, and (2) θR is concave in θ with a unique maximizer at $\theta^{o} \epsilon (\underline{\theta}, \overline{\theta})$, i.e., $\partial(\theta R)/\partial\theta|_{\theta = \theta^{o}} = 0$.

The deposit insurer's problem is to design a pair (p, D) where p is the periodic deposit insurance premium per dollar of deposits, and D is the bank's permissible deposit level. As indicated earlier, the latter translates into a capital requirement. We assume that the bank's asset choice cannot be observed ex-ante by the insurer, and cannot be deduced ex-post in a mutually verifiable way. This creates moral hazard.

For a given (p, D), the bank's first choice is whether or not to be insured. We assume that if the bank chooses not to purchase deposit insurance, it cannot obtain deposits. Thus, the combined expected payoff for the bank and the borrower is zero. This is just a normalization that stipulates the bank's reservation payoff. If it chooses to participate, the bank's second decision

is on values of θ. Using equation (2), we can now write the bank's objective as that of maximizing

$$\pi = \theta R + Dr_f [1 - \theta - p] - Ir_f, \qquad (7)$$

with its choice of θ. This is given by the first-order condition

$$\partial\pi/\partial\theta = \partial(\theta R)/\partial\theta - Dr_f = 0. \qquad (8)$$

Let the θ satisfying (8) be θ^{*}. Thus, we see from (8) that $\theta^{*} = \underline{\theta}$ in Case 1, unless D = 0. That is, for any pair (p, D), the bank chooses the riskiest project. The deposit insurer can set its breakeven (zero subsidy) policy as follows: (i) fix some D and assume $\theta^{*} = \underline{\theta}$, and then (ii) set $p = 1 - \theta^{*} = 1 - \underline{\theta}$. This will be a breakeven pricing policy since the bank will choose the riskiest project when faced with this (p, D) pair.

For Case 2, we see from (8) that $\theta^{*} < \theta^{o}$, unless D = 0. Once again, the deposit insurer can set its breakeven policy as in Case 1.

Thus, we find that moral hazard induced distortions are unavoidable with a single-period horizon, given that banks emit insured deposits. Note that, unlike the private information case, providing a subsidy does not solve the problem.

B. Two Period Model

We will first focus on Case 1, where θR = constant. The initial period begins at t = 0 and ends at t = 1, and the second begins at t = 1 and ends at t = 2. At t = 0, the bank lends to a borrower who invests in a project that at

$t = 1$ yields $R(\theta_1)$ w.p. θ_1, and zero w.p. $1 - \theta_1$. At $t = 1$, if the project is unsuccessful, the borrower defaults, the deposit insurer repays the bank's depositors and the bank expires. If the project succeeds, the loan is repaid, the bank repays depositors and continues for another period. At $t = 1$, new deposits are received, and a new loan is negotiated. At $t = 2$, this loan yields $R(\theta_2)$ w.p. θ_2, and zero w.p. $1 - \theta_2$.

The deposit insurer's problem is to design $\{(p_1, D_1), (p_2, D_2)\}$, where (p_i, D_i) is the periodic premium per dollar of deposits and deposit level pair for period i. Of course, (p_2, D_2) is offered conditional on first period success. The combined expected payoff of the bank and the borrower for period i is

$$\pi_i(p_i, D_i) = \theta_i R(\theta_i) + D_i r_f [1 - \theta_i - p_i] - Ir_f. \tag{9}$$

The bank's objective at $t = 0$ is to maximize

$$\tilde{\pi} = \pi_1(p_1, D_1) + \theta_1 r_f^{-1} \pi_2(p_2, D_2), \tag{10}$$

where all payoffs are normalized in time $t = 1$ dollars. The first-order condition governing the optimal choice of θ_1 is

$$\partial\tilde{\pi}/\partial\theta_1 = \partial(\theta_1 R(\theta_1))/\partial\theta_1 - D_1 r_f + r_f^{-1} [\pi_2(p_2, D_2)] = 0. \tag{11}$$

Note that π_2 may include a subsidy for the second-period deposit insurance.

The deposit insurer can select (D_1, p_2, D_2) so that

$$D_1 r_f \le r_f^{-1} [\pi_2 (p_2, D_2)]. \tag{12}$$

Since $\partial(\theta_1 R(\theta_1))/\partial\theta_1 = 0$ by assumption of Case 1, (11) implies that the insurer can induce a choice of $\theta^* = \bar{\theta}$ (the project with the lowest risk) if (12) is satisfied. That is, in the first period, first-best project choice incentives can be enforced by appropriately choosing D_1, D_2 and p_2. To further analyze (12), write out π_2 as

$$\pi_2 = [\theta_2 R_2 - Ir_f] + D_2 r_f[1 - \theta_2 - p_2],$$

and defining $\Delta(\theta_2) = \theta_2 R_2 - Ir_f$, we have

$$\pi_2 = \Delta(\theta_2) + D_2 r_f[1 - \theta_2 - p_2]. \tag{13}$$

Now substituting (13) in (12), we obtain

$$\bar{\Delta} r_f^{-1} + D_2[1 - \theta_2 - p_2] \ge D_1 r_f. \tag{14}$$

Note that in the second period, the bank will choose $\theta_2 = \underline{\theta}$ for any $D_2 > 0$. That is, the end-game problem precludes a resolution of the moral hazard in the second period. Thus, we can write (14) as

$$D_2 [1 - \underline{\theta} - p_2] \ge D_1 r_f - \Delta r_f^{-1} \tag{15}.$$

Suppose $\Delta(\theta_2) = 0$, i.e., borrowers have only marginal (zero NPV) projects.

Then, (15) implies that, as long as $D_1 > 0$, a subsidy in the second-period is necessary to ensure that the bank will choose the low-risk project in the first period. In general, with $\Delta(\theta_2) > 0$, a second-period subsidy is necessary to control the first-period moral hazard problem when the contractual payout on the first-period deposits exceeds the discounted value of the social surplus from the second-period project, evaluated at time 1.

For Case 2, from the results of the single period model, the bank will choose $\theta_2^* < \theta^o$ in the second period, unless $D_2 = 0$. The bank's first-period asset choice, θ_1^*, is determined by the first-order condition (11). Substituting (13) into (11), we see that $\theta_1^* = \theta^o$ if and only if $D_1 r_f - \Delta(\theta_2^*) r_f^{-1} = D_2 (1 - \theta_2^* - p_2)$. The interpretations are similar to those in Case 1. Suppose $\Delta(\theta_2^*) = 0$, a subsidy in the second period is necessary to ensure first best in the first period as long as $D_1 > 0$. In general, with $\Delta(\theta_2^*) > 0$, a second period subsidy is necessary when the contractual payout on the first period deposits exceeds the value of the social surplus from the second-period project evaluated at time 1.

Thus, we find that in a one-period setting, a deposit insurance premium linked to a capital requirement will not solve the moral hazard problem. In a two period setting, the moral hazard problem can be resolved only with restrictions on D_1 and D_2, and possibly with a second-period deposit insurance subsidy.

V. INTERPRETATION

A. Robustness of Results

In this subsection we discuss ways in which the model can be extended without altering the results.

(1) Alternative Objective Functions: We obtained our main result about subsidies by assuming that the bank maximizes the combined welfare of its shareholders and the borrower. However, in the private information case, our results are independent of how the surplus from the borrower's project is shared. The key is that deposits must be special in order to use capital requirements as an effective sorting instrument.[12] In the moral hazard case, assuming a specific credit market structure that implies some sharing of the surplus only strengthens our results. For example, suppose the credit market is perfectly competitive so that the borrower captures all of the surplus, i.e., the loan interest factor is $r_f \theta^{-1}$. In this case, it is impossible to resolve the moral hazard problem without subsidies, even in a multi-period setting.[13] Since the total surplus from the borrower's project is never less than the surplus accruing to the bank under any market structure, assuming some other objective function for the bank increases the importance of subsidies in coping with moral hazard.

(2) Multiple Bank Types and Arbitrary Payoff Distributions: We have assumed that, in the private information case, there are only two types of banks. Suppose a continuum of types that can be rank-ordered on the basis of risk. In this case we will find that, in the absence of subsidies, only the riskiest bank will be allowed to have deposits. All others will be required to fund entirely with capital. The reason is that the riskiest bank will covet the allocation of any less risky bank that is awarded a lower periodic deposit insurance premium per dollar of deposits with any quantity of deposits. Thus, subsidies are essential in this more general case.

Subsidies are also essential when each borrower's payoff is described by an arbitrary probability distribution. To see this, suppose each borrower's payoff has a continuous density function and borrowers can be rank-ordered on the basis of first- or second-order stochastic dominance. Then, the deposit insurer's liability per dollar of insured deposits is greater for riskier banks, implying a higher periodic premium per dollar of deposit. Subsidies will once again be needed for an incentive compatible, risk-sensitive deposit insurance pricing scheme that permits banks other than just the riskiest to fund with deposits.

(3) Risk Averse Depositors: Our analysis has been carried out in a risk neutral setting which raises the obvious question of why deposit insurance is needed. While we take the provision of deposit insurance as given, we implicitly assume that depositors are relatively small, risk averse individuals for whom it is desirable to have a risk-free, liquid investment opportunity. In such a setting we can imagine that all economic agents are risk averse and that there are systematic as well as unsystematic risks inherent in security payoffs. Since bank equity will be priced on the basis that shareholders are well-diversified, only a premium for systematic risk will be required. The completely insured depositors will demand a return equal to the riskless interest rate. Fair pricing of deposit insurance requires that the insurance premium should compensate the deposit insurer for the difference between the yield on uninsured deposits and the riskless rate (see Merton (1977)). Given such fair pricing, however, it is clear that the effective risk-adjusted yield on deposits equals that on equity for the bank. Thus, the bank is indifferent between deposits and equity.[14] Anything less than such a premium should be viewed as a subsidized deposit insurance price in the sense that the insurer is inadequately compensated for risk. Our main result is then sustained in this more general framework.

The only case in which it seems possible to implement an incentive compatible, risk-sensitive deposit insurance scheme in a competitive market setting without the deposit insurer incurring a loss is when the insurer is risk neutral and all other agents are risk averse. In this case, deposit insurance that is priced to enable the insurer to just break even can still generate a positive surplus on deposits for the bank due to risk-sharing benefits. Deposits would then be special relative to (uninsured) equity, and one could implement a risk-sensitive pricing scheme that overcomes private information problems. However, note that this result stems from the assumed role of the deposit insurer as the sole risk neutral agent in the economy. If there were other risk neutral insurers (either because of inherent risk neutrality or because all relevant risks are idiosyncratic) in the private capital market, they could provide competitively priced insurance for equity that would enable them to just break even and generate as much risk sharing surplus for (risk averse) shareholders as deposit insurance does for depositors. Once again, the bank would be indifferent between deposits and equity.

(4) Monitoring: In practice, deposit insurers rely on monitoring through bank examinations as a means of coping with both private information and moral hazard problems. Could a risk-sensitive deposit insurance pricing scheme be constructed that exploits monitoring, rather than direct reporting by banks? Unfortunately, monitoring in an environment devoid of subsidies is likely to be inadequate for two reasons. First, as far as private information is concerned, monitoring is more costly than direct reporting by banks. To recoup this cost, the deposit insurer must gross up the premium it charges banks. Unless deposits have a "built-in" surplus relative to equity, banks

will prefer to fund entirely with equity or uninsured liabilities, rather than pay the monitoring cost of insured deposits. Second, as far as moral hazard is concerned, monitoring can be effective only if the insurer can credibly threaten to punish excessive risk taking exposed by the monitoring. The most severe punishment is termination of the bank charter. However, in a competitive environment without subsidies, charter termination imposes no loss on the bank.

B. Policy Implications

Are we to conclude that an incentive compatible, risk-sensitive insurance pricing scheme could never have been possible? The answer is no. In the past, when depository institutions were more tightly regulated and entry was controlled, deposit-related rents were available.[15] The low failure rates among banks and thrifts in earlier years supports the existence of these rents. Thus, deposits were "special" and the existing subsidies could have facilitated risk-sensitive deposit insurance pricing. Our results therefore relate to the timeliness of risk-sensitive insurance premia. Deregulated banking and risk-sensitive insurance pricing seem incompatible.

VI. CONCLUDING REMARKS

We have shown that fairly priced insurance, and by implication, competitive insurance of deposits by the private sector, may be impossible where private information and moral hazard distort equilibria. To resolve these problems in the design of an efficient, incentive compatible scheme, subsidies to banks are required.[16] This finding is independent of the choice of a sorting instrument. The same result would be obtained if we had chosen to sort on some variable other than capital. With a risk-sensitive deposit insurance pricing system, high-risk banks always have an incentive to misrepresent in the hope of securing lower premia. Thus, some inducement is required to encourage candor. An appropriately designed subsidy could elicit truthful revelation, but in a completely deregulated or perfectly competitive environment, there can be no instrument to coax the truth.

Our message is one of historic irony. Risk-sensitive incentive compatible deposit insurance might have been possible earlier when banks and thrifts enjoyed substantial deposit-related subsidies. However, the existence of these subsidies probably mitigated the need for risk sensitive premia since the subsidies provided incentives for banks and thrifts to choose low risk assets. The value of the bank charter, which subsumed the deposit rents, served as a bankruptcy cost conditioning the selection of assets. Now that these deposit subsidies have been dissipated, banks' and thrifts' incentives to take risks are enhanced, and the need for risk-sensitive premia is likewise increased. But, without the subsidies a fairly-priced risk sensitive insurance system may be unattainable.

ENDNOTES

1. By fair pricing we mean that the insurance is priced to enable the insurer to break even on each institution, individually.

2. Let us sidestep the serious issues relating to RAP and GAAP accounting for thrifts and banks.

3. The only other examination of deposit insurance in the context of incentive compatibility we are aware of is Kanatas' (1986).

4. As we point out later, our results are sustained even if regulatory subsidies are transmitted through means other than underpriced insurance, provided the subsidies are deposit related.

5. Although both moral hazard and private information problems associated with deposit insurance are well recognized, many believe that the signaling and disciplining capabilities of risk-sensitive insurance pricing can overcome these problems. An example is the following from The Economist, March 26, 1988, p. 18,

> "The insurance fund has already tried - - fruitlessly - - to persuade Congress to allow it to charge different insurance rates for different sorts of banks. Such differentiation would do something to raise more insurance money and vaguely discourage risky banking. But the problem of moral hazard needs more than that: bank depositors should be given more choice between risk and security, and know what the security is costing them.
>
> . . . On an insured account, depositors would get the bank's published rate less a published insurance premium. Calculated by the FDIC, this would vary according to a bank's health - - measured by such symptoms as its non-performing loans, the size of its equity compared with its assets, and its overall profitability. A rise in Bank Furioso's premiums would raise the cost of its funds and give its uninsured depositors some idea of the risk behind Furioso's handsome interest rates. Such signals would force banks that were doing badly to run themselves more prudently. (Emphasis ours).

6. Our presumption is that private insurers are not themselves subsidized by the government, so that they must price deposit insurance fairly, although not necessarily on each individual bank.

7. Multiple borrower types are considered in Section V.

8. Our results generalize to arbitrary probability distributions.

9. Besanko and Thakor (1988) show how the surplus from investment projects is shared by contracting agents in imperfectly competitive credit markets.

10. We assume that loans are unsecured. For an analysis of how collateral affects credit market allocations, see Besanko and Thakor (1987).

11. Note that the incentive compatible schedule has a premium, p, per dollar of deposits that is a function of D such that the total premium pD is nonlinear in D, whereas the existing arrangement has p constant, so that pD is linear in D.

12. The intuition of this result is akin to that in Shah and Thakor (1987) wherein incentive compatible capital structure contracts can be designed to induce a perfectly separating equilibrium in which firms with levels of risk that vary along a continuum choose distinct debt to equity ratios. In their model, it is essential that debt payments be tax deductible. Thus, a tax advantage of debt permits separation. Without taxes, the original Modigliani and Miller (1958) irrelevance proposition applies and firms are indifferent between debt and equity. This is similar to our result where without subsidies banks are indifferent between deposits and capital and sorting is impossible. Note, however, that the tax deductibility of deposit interest payments for banks does not suffice to permit separation in the present model. Taxes only make deposits different from shareholders' equity, but not from debt claims subordinated to deposits. These claims are part of the regulatory definition of capital. Thus, we again have indifference between deposits and capital when there are no subsidies. We have assumed taxes are zero, which means capital can be defined, without loss of generality, as consisting only of equity.

13. This is true regardless of the time horizon. Even if the credit market is perfectly competitive, banks that receive subsidies will have positive charter values. They will not compete away these subsidies through their loan pricing because they have the option to invest in marketable securities. In a risk neutral world, a bank will, therefore, never invest in an asset that yields an expected return lower than the riskless rate.

14. In this framework, one reason why the deposit insurance is provided by a federal insurer rather than, say diversified shareholders, is credibility. Shareholders may not be able to provide a credible commitment to make the stipulated payoffs.

15. In fact, this is often offered as one explanation for the recent growth of securitization. When deposit funding was advantageous because of the associated rents, it was efficient for banks to combine the credit functions of origination and funding. The dissipation of these rents, however, has stripped away the funding advantage, leading banks to separate the two credit functions and focus on origination (see Greenbaum and Thakor (1987)).

16. The magnitude of the optimal (minimum) subsidy depends on the minimum deposit level the regulator wishes to achieve. Ceteris paribus, larger deposit levels can only be supported with larger subsidies per dollar of deposits. Thus, the total subsidy granted will be increasing and convex in the desired deposit level.

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The **Chairman**. Thank you, Mr. Greenbaum, and I want to thank all of the witnesses.

We are only going to have 5 minutes because we have a number of Senators here to ask questions. So I am going to ask you to make your responses as concise as you can.

Before I ask my first question, however, I would like to make it clear that no matter what the condition of the savings and loan industry and no matter what the financial status of FSLIC, there is absolutely no doubt that the U.S. Congress stands behind our deposit insurance program.

Also, there is absolutely no doubt that any insured deposit in a savings and loan association is a safe deposit.

I believe I speak for every member of the committee on this, and I think that word has to go out, particularly in view of the honest and realistic assessment that you have made, but an assessment which could obviously have a self-fulfilling aspect if it weren't clear that the people who put their money in savings and loan have no worry if $100,000 or less.

I would like to take another minute to read from the law that was put into effect on August 10:

> Congress finds and declares that since the 1930's, the American people have relied upon Federal deposit insurance to insure the safety and security of their funds in federally insured depository institutions, and the safety and security of such funds is an essential element of the American financial system.
>
> In view of the findings and declarations contained in this subsection, it is the sense of the Congress that it should reaffirm that deposits up to the statutorily described amount in federally insured depository institutions are backed by the full faith and credit of the United States.

That was less than 1 year ago. I am sure Congress will continue to take that position so that there should be absolutely no fear on the part of anyone who has deposits or would make deposits in a savings and loan that those deposits are safe up to $100,000.

Now, I have got several questions I would like to ask each of you to answer with a single number or a single word. [Laughter.]

What is your—I would like each of you in turn to answer—what is your best estimate of the total cost of resolving all of the insolvencies in the savings and loan industry over the next 5 years?

Mr. Wolf.

COST OF INSOLVENCIES

Mr. **Wolf**. If you want a single number, I would put it at between $30 and $35 billion.

The **Chairman**. That is two numbers, but that is fine.

Mr. **Wolf**. $32.5 billion.

The **Chairman**. Mr. Ferguson.

Mr. **Ferguson**. I would have approximately the same estimate as Mr. Wolf.

The **Chairman**. Mr. Ely.

Mr. **Ely**. $64 billion as of the end of 1987.

The **Chairman**. Did you say $54 billion or $64 billion?

Mr. **Ely**. $64 billion.

The **Chairman**. $64 billion.

Yes, sir, Mr. Silverberg.

Mr. **Silverberg**. $50 billion, but growing by more than the rate of interest the longer you delay. So $50 billion now and growing more than the cost of delay, cost of the deferring of interest.

The **Chairman**. Mr. Greenbaum.

Mr. **Greenbaum**. I said $25 to $50 billion in my written testimony, but I lean toward the greater of the two bounds of that range, and indeed the final number is very sensitive to the policies we pursue to clean up the mess.

The **Chairman**. OK. Now, another question—again I hope you will confine it to one word or one short sentence—given your estimate of the size of the problem, what is your best estimate of how much taxpayer money will be required to solve the problem?

Mr. Wolf.

Mr. **Wolf**. I am not sure yet that taxpayer money will be involved. I don't want to say that it is not possible, but I am not going to put a number on that.

The **Chairman**. Mr. Ferguson?

Mr. **Ferguson**. I would not put a number on it at this time either, sir.

The **Chairman**. I am not getting much satisfaction out of this question.

Mr. **Ely**. I will give you a number. It is in the range of $40 billion.

The **Chairman**. Mr. Silverberg.

Mr. **Silverberg**. In the 30's.

The **Chairman**. Mr. Greenbaum.

Mr. **Greenbaum**. I think I can associate with those two estimates.

The **Chairman**. I didn't get that, Mr. Greenbaum. [Laughter.]

Mr. **Greenbaum**. I said I can associate with those two at $30 billion and $40 billion. I think those are reasonable numbers.

The **Chairman**. All right.

Mr. **Greenbaum**. Those are reasonable numbers.

The **Chairman**. Now, again I am going to ask for the same kind of concise response.

The GAO testimony revealed that the Bank Board's revenue projections are conditioned on the continuation of the special assessment. Such continuation would encourage S&L's to become savings banks insured by the FDIC, which imposes smaller premiums. Such attrition in the S&L industry would exacerbate the FSLIC financial difficulties.

To delay this problem, Congress imposed a moratorium on leaving the industry in CEBA, in that bill we passed last year. That moratorium is due to expire in August.

Would you recommend that Congress extend the moratorium on thrift transfer to the FDIC?

Yes or no, Mr. Wolf.

Mr. **Wolf**. You are talking about a policy question. I am going to hedge a little bit on that.

The **Chairman**. Well, I want a——

Mr. **Wolf**. There is not a known answer in terms of whether there will be large numbers of institutions that leave, and in fact they have to first meet the FDIC's capital requirements in order to be able to move over there.

There is a risk that if the moratorium goes off that you will have movement. To the extent that you have movement, you then clearly move into the posture of it making it much more difficult for the industry to pay for the problems——

The CHAIRMAN. Mr. Wolf, should we extend the moratorium or not? Yes or no.

Mr. WOLF. I don't think I would, but that is a personal answer.

The CHAIRMAN. You wouldn't. That is fine. That is all I wanted. Thank you.

Mr. Ferguson.

Mr. FERGUSON. No, sir.

The CHAIRMAN. Yes, sir, Mr. Ely.

Mr. ELY. The moratorium should not be extended.

The CHAIRMAN. No.

Yes, sir, Mr. Silverberg.

Mr. SILVERBERG. I have two answers there. If Congress seriously addresses the problem fairly early next year, then I would extend the moratorium. Otherwise, I would not.

The CHAIRMAN. Mr. Greenbaum.

Mr. GREENBAUM. I would say "no" in order to prompt other action by Congress.

The CHAIRMAN. All right. I have one other question.

As you know, the Bank Board has discretionary authority to phase out the special assessment levied by FSLIC. Given your assessment of the condition of the industry, tell us if you believe the special assessment should be continued at its present level.

Again, Mr. Wolf.

Mr. WOLF. Two points. If you don't continue it, the financing is not there to cover the problem. If you do continue it, you run the risk that you put more institutions into financial difficulty.

The CHAIRMAN. Well, would you continue it or not?

Mr. WOLF. Now I would continue it, yes.

The CHAIRMAN. You would continue it.

Mr. WOLF. I would continue it, but I would watch it pretty closely.

The CHAIRMAN. Yes, sir.

All right, Mr. Ferguson.

Mr. FERGUSON. I think that in the best interest of the solvent institutions it needs to be removed as quickly as possible, but for the present time I would say you would have to continue it.

The CHAIRMAN. All right, sir.

Mr. Ely.

Mr. ELY. The healthy thrift institutions pay far too much for their deposit insurance. The special assessment should be removed.

The CHAIRMAN. Yes, sir.

Mr. Silverberg.

Mr. SILVERBERG. I would continue it for the time being, but I would take it off in connection with a package that would deal with the problem.

The CHAIRMAN. Mr. Greenbaum.

Mr. GREENBAUM. I would like to see a scheduled removal of the special assessment. I would like to see it phased out.

The CHAIRMAN. Thank you.

Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

First of all, let me follow on what you were saying because although these hearings are necessary and important they worry me. I have been sitting here for 14 years and I have learned to watch people's faces and I have particularly learned to watch what the press writes down. You can almost always predict when their pencils are going to start going—when they hear something juicy, some morsel that will go quickly on the news the next day.

So we are flipping $64 billion around and $30 billion. First of all, the statement I would make is that none of us are right, and anybody that reports these figures as a fact is a damn fool because you simply cannot pull figures out of the air the way all of us are doing, including 2 years ago when I said $30 billion. That was essentially off the top of my head.

So I hope people will be responsible and recognize that there is a very serious problem that we are trying to address; but to hang on particular numbers is a game we are playing, and it is not possible for anybody to pull those kind of figures and be accurate, particularly Mr. Ely. At least the rest of you have some range.

But to pick $64 billion, I am sorry, Mr. Ely, that is ridiculous. You can't do that. You cannot stand here and tell me that you can stand your reputation behind picking 64, 34, 75, or anything else.

So let's put all of that in perspective and not panic the American people.

The CHAIRMAN. Senator Garn, if you would just yield for a second.

I asked for a single figure, and it is my fault.

Senator GARN. No, no, no.

The CHAIRMAN. I think Mr. Ely made a proper response. He may have been right or wrong, but he said 64, and it is my fault that I asked for one figure, not a range.

Senator GARN. No. In his testimony he had 64. I am just trying to put some perspective on this.

Let's not overreact to the general situation. Mr. Greenbaum made a very important statement, and was the only person who had anything positive to say.

I can remember when Continental Illinois failed and the Chairman of the Federal Reserve Board, Paul Volcker, called me. He said we have got a panic situation going on, will you place calls to some major depositors in Manny Hanna and other banks. There were a lot of people making calls as a result of a report on other institutions that were not in trouble at all.

That is my point. To follow up what you are talking about, Mr. Chairman, let's not run out of this place and panic the American people so that we create self-fulfilling prophecies.

That is why I went at quite great length in my opening statement to talk about why this has been a continuing problem for some time. The numbers are not new. That is why I made a point of saying I thought it was a much bigger problem 2 years ago than many other people believed.

I want to keep it in perspective so that we are not scaring people into running to their savings and loans, taking money out, and making these gentlemen true prophets of their own numbers. There are positive things going on as well.

I don't want to minimize the problem, but I don't want to have it exaggerated either. The statement you made, Mr. Chairman, is very important. With all of this trouble over the last 8 or 9 years, not one single depositor with funds federally insured up to $100,000 has lost one dime of an insured deposit. That message needs to go out of this chamber rather loud and clear.

I want to put things in perspective so we are not creating unnecessary problems as a result of this hearing. We should look at this objectively, recognizing the seriousness of the problem, and try to do something about it.

Mr. Wolf, the news media is reporting this morning that you said FSLIC's problems exceed $50 billion.

How do you explain the discrepancy between your written testimony, your answers today, and what the news media is reporting?

Mr. WOLF. I did not talk to anybody from the press yesterday. I delivered our statement to this committee, and the numbers that are in that statement stand.

Senator GARN. Well, I understand. I just wanted to make sure. This is an example of what I am talking about. $50 billion is such a nice round number, and I don't want to create problems that make the situation worse than it already is.

Mr. Ely, in terms of wild variations, you say 849 institutions are hopelessly insolvent and have a negative net worth under GAAP of $64 billion. GAO, which is FSLIC's independent auditor, says 505 institutions have a negative net worth under GAAP accounting of $18.9 billion.

Your numbers are over three times greater than GAO's on institutions that are clearly brain dead. This is a huge variation.

How do you react to each other's numbers? Why the huge variation? Why such a difference between experts?

Mr. ELY. The number that I have for the 849 institutions is a negative $10.8 billion on a GAAP basis.

The reason my estimate is so much higher is that there is a tremendous amount of unrecorded losses in these institutions. A very good example is what allegedly occurred recently at Sunbelt Savings, which in the first quarter of 1988 reportedly recorded a $1.2 billion loss. That loss didn't occur overnight. It had been building for years. It was there, and it finally surfaced.

And I suggest to the committee that we have a number of other thrifts in exactly that situation.

The analytical techniques that I use, in which I analyze the financial numbers on every single thrift, try to ferret out those losses that have not yet been reported in thrift financial statements.

Senator GARN. The point I am trying to make is there is a wide variance.

To get back to my overall caution of not overreacting to this situation, I would like each of you to submit to the committee in writing an analysis of the validity of the others' numbers. [Laughter.]

Mr. Wolf, may I raise a technical point?

I understand that the American Institute of CPA's raises some questions about whether FSLIC notes should be considered an asset of a thrift.

The U.S. Congress has declared time and time again, that federally insured depository institutions are backed by the full faith and credit of the United States, and the chairman read that statement in his bill of last year to you this morning.

Do you believe that their notes should be considered as an asset of an insured institution?

Mr. **Wolf**. Yes, I do. I subscribe to what was said by the chairman and by you. We have had two resolutions by Congress that clearly state that they are going to stand behind the insurance program. We have had a $10 billion recap bill that was passed. In a similar problem situation with Farm Credit Congress acted in time to ensure that people didn't lose money there.

Therefore, I do not consider it likely that anybody is going to lose money on those notes.

I have a caveat that I would put out there, not in terms of the collectibility, but in terms of something that I think is going to be useful for your committee and for the Bank Board, and that is, right now the Bank Board has not clearly said how much FSLIC will go up to in terms of notes.

There isn't an unlimited note-writing ability for the Bank Board. They can't just write notes to the tune of $30 and $40 billion. If they don't clearly say we are going this far and that is as far as we will go, then you always will have people raising questions.

The cash flow projections which they have provided to us would indicate about $6 billion this year, $4 billion more next year. While we have some reservations about those projections, it would seem to me that a clear statement by the Bank Board that we will not go beyond a specified amount, or something like that, would go a long way to resolving part of that problem because I think there is uncertainty in terms of can they just continue to issue notes.

But ultimately, no, I don't think anybody is going to lose money on those notes.

Senator **Garn**. Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Garn.

Senator Shelby.

Senator **Shelby**. Thank you, Mr. Chairman.

Mr. Chairman, I want to commend you for your statement reassuring the American people that the Congress is going to stand behind depositor insurance. I believe you speak for this Committee and for most of us in the Senate. We are going to stand behind the insurance. No one has lost anything, as Senator Garn has said.

But I believe we have two questions here, and I want to commend the panel. We asked you here today to listen to you. All of you have pointed out the seriousness and the precariousness of the thrift industry and you have warned us about where are we going.

Whether we are going to need $30 to $35 billion or $50 billion or $40 billion or $64 billion, all of you are pointing out that it is vast, real problem. We should seek the truth here. The press has an obligation to report it.

Two things. One, we are going to reassure the depositors that they are not going to lose the money. At the same time we are going to have to come up with some money one way or the other. The question is whether it is going to be in the range of $30 to $35 billion, $20 billion—I haven't heard that figure—$64 billion or 40 billion?

I would say it is probably going to be on the high range. I don't know. Perhaps a lot of it will depend on several other factors that you all have pointed out.

But I want to ask the panel, as interest rates begin to increase, what role is that going to play as far as the thrift industry's problems?

It has played a big role in the past. I have to think it will affect the solvency of many institutions and the ultimate cost of solving the industry's problems?

Yes, sir, Doctor.

INTEREST RATES

Mr. **Greenbaum**. I think there are three questions here. First, it is significant to know what the number is. I mean, everyone wants to know. It is important to know.

The problem is that the number is unknowable.

Senator **Shelby**. You are giving a judgment.

Mr. **Greenbaum**. Yes. The amount it will cost to fix the thrift problem will depend on how quickly we choose to fix it, and how we choose to fix it. If we continue to pursue a delaying strategy, as we have in the past, there are three related problems.

One is we have managers out there with inappropriate incentives. They are taking on more risk than they should, and that is a public problem.

We also have an industry that is fragile and will be further by impaired either by a run-up in interest rates or by a significant recession.

So we have those three exposures to worry about. If we didn't have the first, incidentally, it is even possible that delay could be an attractive strategy. Without the moral hazard we could keep the issue open, see interest rates go down, and the losses might drop considerably.

So it is not a slam dunk. But the consideration that tilts this whole issue toward dispatch, toward a quick resolution is the fact that we have 500, 700, 600 institutions out there being run by people with inappropriate incentives, and that is bound to cost us if we continue to let them play.

Senator **Shelby**. Let me ask all of you this question. What is the upside of merging two insolvent thrifts? In other words, is that delaying the real problem?

I don't know what the positive features are there.

Mr. Ely.

MERGING TWO INSOLVENT THRIFTS

Mr. **Ely**. I think there is, by and large, little upside. Although there is discussion of economies that can be achieved, we still end up with a bigger insolvent thrift. We will spend a lot of money, unwisely, trying to consolidate operations in a surviving institution that itself has little chance of survival. What we create is a bigger problem that is going to be even harder to dispose of in the future. One of the real drawbacks of the Southwest Plan is that it proposes to consolidate without at the same time restoring capital viability. Without the capital viability, consolidation is a very questionable exercise.

Senator **Shelby**. How long is it going to take to resolve the thrift crisis? Years?

Mr. **Ely**. It depends on how fast we want to move. The key is putting a lot of cash into the situation quickly to either liquidate or shrink and sell off the insolvent institutions. I think it could be done in 2 to 3 years, but it is going to mean spending $40 billion plus of taxpayer money to do it.

Mr. **Silverberg**. I would agree with the 2- or 3-year possibility. I think it is important—I mean, you may get some benefit from delay from lower interest rates, but I think the odds and the expected results suggest delay is going to be very expensive.

I think the benefits of stretching things out are very illusive, and one of the big benefits of getting the job done quickly is that you are not putting a tremendous strain on the rest of the institutions.

Incidentally, I just wanted to add I agree with everything that Mr. Greenbaum said, but there is an additional cost associated with what we have got, relates to the way failed banks, failed S&L's, are handled. If FSLIC had much more cash available, the options available to FSLIC in doing the transaction, for example, that was announced yesterday would be quite different. Their options are constrained by the need to preserve cash, and as a result, there may be a couple of other options, one of which might be closing out those four weak institutions. That might turn out to have been a cheaper option. But that is not available to them.

Mr. **Ferguson**. Senator, in many cases I think the benefits of merging two insolvent thrifts are probably not great enough to be worth the effort to go through the exercise.

You had a transaction in Iowa a few weeks ago that looked very much like the transaction that was done during the last 2 weeks, this week and last week, in Texas, and I think the Southwest Plan may have gotten a bad rap just because of the massive number down there.

But the Coastal Bank merger that occurred 2 weeks ago that was reported in the press, I did an analysis on it based upon the press release of the Federal Home Loan Bank Board and what was recorded in the newspapers. The transaction seemed to make sense, and it did much more than simply throw five insolvent thrifts together. It actually did infuse capital into it, according to FSLIC's press release. It was FSLIC's capital, but nevertheless it was capital.

Senator **Shelby**. Anyone else?

Mr. **Greenbaum**. I think there are a couple of possible benefits to the merger of two weaker institutions. One is you may be able to husband some good management. If one of the two institutions is demonstrably well-managed, you get a real benefit there.

Now, if the two institutions happen to be in the same market, you can exploit opportunities to reduce overhead costs by closure of redundant branches, and that can be a benefit.

I would say those are the two major potential benefits obtainable by that kind of a merger, but the danger is that you still have an undercapitalized institution with incentives that are not aligned with the insurer. That is the problem.

Senator SHELBY. My time has expired. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Gramm.

Senator GRAMM. Mr. Chairman, I understand that all of our witnesses here believe the problem is bigger than we currently are structured in the Federal Home Loan Bank Board to deal with.

I would like to ask everybody, when we had the debate last year as to how much FSLIC recapitalization ought to be, whether it ought to be $5 billion, as the League proposed, or $15 billion as we had adopted the year before, I would like to ask each one of you where you were and where were the people that you work for.

Could we just start down on the end with Mr. Wolf?

Mr. WOLF. A year ago we testified on the House side on that issue. We said that $15 billion at a minimum was needed and that the total cost was between $25 and $35 billion, about where we are today.

Senator GRAMM. Mr. Ferguson.

Mr. FERGUSON. Our firm prepared a paper on the situation, particularly in Texas, not the United States as a whole, approximately a year ago, which, while it was not admitted in any of the hearings, was submitted to the Federal Home Loan Bank Board, and other regulatory agencies. It was also submitted to several Members of Congress, and I think possibly even the Banking Committee.

We said in that paper that at least $15 billion would be necessary in order to solve the problem, and that was the United States as a whole. First we analyzed Texas and then developed projections for the rest of the United States

Frankly, over the past year in Texas, what we have seen, Senator Gramm, is that the problem has just continued to deteriorate. I don't think any of us had a crystal ball—certainly I didn't have a crystal ball a year ago or even a year before that—and I am amazed at how depressed the economic environment became—and how tragic the results for the thrift industry down there have become.

Senator GRAMM. Mr. Ely.

Mr. ELY. In the summer and fall of 1986, when the FSLIC recapitalization plan was first under discussion, I wrote articles for the Wall Street Journal, the American Banker, and the Washington Post stating unequivocally that the recap plan was doomed to failure. I also estimated that FSLIC's accumulated loss at the end of 1985 was in a range of $29 billion.

Mr. SILVERBERG. Last summer, before the recap bill was passed, I did a paper for the National Council of Savings Institutions related to developing a plan for them, and I think my estimate was at least $35 billion, but in any case substantially greater than $10 or $15 billion.

Mr. GREENBAUM. The position I took at the time was that the $15 billion would be inadequate to deal with the problem. But I did have doubts about allocating that much money to a regulatory agency which at the time didn't seem well-equipped to handle the resources. That led me to be concerned about the allocation.

Senator **Gramm**. Well, let me say, Mr. Chairman, I don't know what happened to all those guys who were saying, "It is not a big problem, it is a little problem. $5 billion will just fix it up fine."

I felt $15 billion was an absolute minimum then. Now, I find all these people who thought it was—or said, at least, that it was this little problem—now, they are all saying, "Well, you know, this is the taxpayers problem." When you cut through all the rhetoric, they are saying that they want the American taxpayer to reach down into his pocket and come up with the money to deal with this problem.

I personally believe it is a big problem. I have been frustrated that we have been so slow getting the Southwest Plan rolling. I think we have bled unnecessarily in trying to move to the day that it started. It started in a big way yesterday. I am delighted with what we did. Patching all of these savings and loans together I think is a risky business.

On the other hand, when Congress gives you $10.8 billion in a self-help program to deal with a big problem, you have to use lots of Band-aids.

I just want to make it clear—and then I want to pose a question to you—I am never going to support a taxpayer bailout, and I do not believe this Congress is going to adopt a taxpayer bailout.

If you started with that premise, what would be your short, sort of burst transmission message as to how you think we ought to deal with it, if you accepted that premise?

And let me begin down on the other end and ask Mr. Wolf.

Mr. **Wolf**. If you have to have a taxpayer bailout?

Senator **Gramm**. No, if you would write that off as something forbidden that came down with the Ten Commandments.

Mr. **Wolf**. That we will have a taxpayer bailout?

Senator **Gramm**. That we will not.

NO TAXPAYER BAILOUT

Mr. **Wolf**. We will not. Excuse me, I misunderstood you.

I think that essentially what we have got is a situation where we are going to have to continue to work through these problems. I think we have got to work through them faster.

If there is a criticism, it is that it has taken us too long to get to where we are.

I understand all the reasons why it takes time and there are a lot of problems, but I don't think throwing tons more money into FSLIC is necessarily the answer. They have got to work through these institutions, and they have got to understand that Congress is going to stand behind the insurance program in the long run so that they have the ability to carry out their job.

Senator **Gramm**. Mr. Ferguson.

Mr. **Ferguson**. I have never felt that there had to be a direct taxpayer bailout. I have felt that Congress and the administration would have to stand behind the pledge that they fully support the safety and soundness of the FSLIC and the FDIC and that this was the important part of any recovery program.

I believe, too, that the process has been too slow and it has been very unfortunate. I also understand the reasons why, and I think many of those reasons are good reasons, why FSLIC hasn't been able to start a major clean up before now.

I think the important thing for the entire system is to get the clean-up started.

I don't think it makes a lot of difference as to what we think the total loss or the total cost of the ultimate resolution will be. If you have to choose between two figures now, sure, you can pick two or pick one or whatever. But I think what does make a difference and what is critical at the present time is that the clean-up be started in order to protect and preserve the rest of the financial institutions that are not insolvent and also potentially the banking system as a whole because if the red ink keeps flowing I have to believe that it will continue to have more and more effect upon the commercial banks in this country, particularly the more poorly capitalized ones.

Mr. Ely. In my opinion, the only way a taxpayer bailout could be avoided would be to confiscate a substantial portion of the private capital that is now invested in the banking system.

However, FSLIC's losses have grown so large that they clearly exceed the effective net worth of the remaining healthy institutions. So even if you took every dollar of net worth in the thrift institutions and, in effect, nationalized the whole industry without compensation to thrift stockholders, you still will not have enough money. So that means reaching beyond the thrift industry.

I am not a lawyer, but I would think at some point in time the question would come up as to what the limits are on the ability of the Federal Government to confiscate capital in that manner.

Mr. Silverberg. I agree. The money just isn't there. I mean, there isn't enough net worth in the system, even if it could be all grabbed, to pay the cost, and I think as you delay, the net worth in the system is going down, the cost is going up.

What you could do is to keep throwing the balls back up in the air and try to delay things, but ultimately that is going to raise the cost of the taxpayer bailout that will have to come, and it will also screw up the whole depository system that we have got.

Mr. Greenbaum. Senator, I think that the premise you offered us is really the preamble to a procrastinating strategy, and I think that the procrastinating strategy will jeopardize potentially successful institutions and probably—but not certainly—it will increase the present value cost of the bailout that will eventually have to be made by the public.

I think there is a certain immutability. You have certain candidates who can absorb the costs, potential claimants to the loss. They have finite resources. The thrift industry can be sacrificed. It is possible that the banking industry can be, too. Ultimately, there will be a residual left to the taxpayer, and we can call it something other than a bailout, but there will be a residual left for them to absorb.

The issue really turns on timing and the ultimate cost that you are prepared to absorb or, in other words, what kind of discount rates you apply to future costs.

Mr. Wolf. Can I add a comment to what I said previously?

I think there is another thing that you need to be careful of right now, and that is that we continue strong regulation of the rest of the industry to prevent other institutions from getting into new types of transactions or other things that are going to get us into trouble 2 years, 3 years down the road.

The Chairman. Thank you.

Senator Graham.

Senator Graham. Thank you, Mr. Chairman.

The questions that have just been asked are along the lines that I wanted to pursue.

It seems to me that we have a difficulty reconciling the statements that were made that the Federal Government has put its full faith and credit behind these institutions and the statement that under no circumstances would we have a taxpayer bailout.

Senator Garn. Would the Senator yield for a clarification?

There is a difference between a bailout of the institutions and guaranteeing that insured depositors will be taken care of up to $100,000.

Senator Graham. I accept that correction of my statement, that the Federal Government has put its full faith and credit behind those depositors up to the limit that we have done and that we would not have a taxpayer bailout.

Mr. Wolf, in answer to the chairman's question of how much taxpayer money would be required in order to solve this problem, I believe you were the only member of the panel who indicated you were not prepared to say that any taxpayer money would be required.

Could you tell us what your scenario would be in order to accomplish that objective, if you have anything to add beyond what you have previously said?

Mr. Wolf. I think there are two parts to it.

First of all, the projections which FSLIC has put together are clearly optimistic in terms of their cash flow and their ability to deal with it. However, they are not impossible to achieve. There are some questions associated with them.

In addition, there are other things that FSLIC does have the authority to do—borrowing through either Treasury, as I recall, through the Federal Reserve, borrowing from the Federal Home Loan Banks, or even ultimately some additional call on the capital of the thrift industry.

So it is not given at this point that we will have to do something that involves taxpayer money, but that is ultimately, I think, going to be a policy decision that Congress is going to have to deal with. Do we take some of these actions? Do we continue the special assessment? Do we require FSLIC to go out into these other sources, or do we say, no, the cost of that is too high because it puts the other institutions that may be healthy, in jeopardy?

So that is a decision that in fact, frankly, I don't think you can make today. I think we are going to have to wait for another year and see how some of these things continue to work out.

Senator Graham. Mr. Chairman, I believe in the next few days we are going to have some representatives of the regulatory agencies testifying.

Is that a correct statement?

The Chairman. I believe it will be next week.

Senator GRAHAM. I am going to ask of those individuals if they could submit in detail their game plan to accomplish the objective of a—I hate to use the word "salvage," but I will use the word—salvage of the industry without the necessity of asking for direct taxpayer support, and I would like those answers to reflect administrative decisions as well as congressional action and action by any other groups that would be appropriate.

The CHAIRMAN. Senator Graham, we will be happy to write the witnesses and ask them to comply with that question when they appear next week.

Senator GRAHAM. And the second part, I would then like to have that game plan submitted to these five individuals for their locker room comment as to whether we can put a team on the field that will successfully execute that game plan.

Having said that, most of you have emphasized a sense of urgency and that while there is some strategy that could justify delay, that in most instances you think that delay would have the result of increasing cost.

With that urgency in mind, what would be your recommendations of what the Congress should do prior to our adjournment later in 1988? What is the 1988 priority?

ACTIONS PRIOR TO 1988 ADJOURNMENT

Mr. WOLF. I'll take a crack at that. I think one of the things that you ought to do, and I don't think it takes legislation, is you ought to make sure that the Federal Home Loan Bank Board or FSLIC clearly state what they're going to do with notes, so that we make sure that there's credibility that they are not going to issue notes beyond what they're able to cover.

And I think the other thing you've got to evaluate is whether you want to postpone the moratorium, or the expiration of the moratorium.

Beyond that, I don't think that there's a great deal that you probably can or need to do right now; other than to see how it works out.

Senator GRAHAM. So you, other than the question of the moratorium, you don't see any congressional action called for in 1988?

Mr. WOLF. No, I don't. They've got to go through part of the process and we've got to see how much some of these things are ultimately going to cost us when we close them before you can decide you need to put additional funds in there.

We said in our testimony we think there's some likelihood that you will ultimately have to do something additional, but I don't think that's now.

Mr. ELY. I think there are two things that Congress can do. First of all, I think it should ask the Bank Board to come up with a precise estimate as to what it thinks the loss is going to be. It should prepare this estimate in such a way that outsiders, particularly the Banking Committee staffs and the GAO, can assess it.

One of the problems we have today is a lack of information from the inside. Related to that, the Bank Board should make more disclosure than it does now of the information it collects on individual thrifts.

There's a paucity of data available on thrifts relative to what the FDIC releases on banks.

The second thing Congress should do is to start taking steps to separate the sick thrifts from the healthy thrifts. The healthy are being dragged down by the sick. In any kind of insolvency situation, private or public, it is important to separate the two categories so that the sick do not infect the healthy any further.

In effect, this means moving the clearly sick institutions into a separate division of FSLIC so that they can be more closely monitored than they are now and not conduct business as usual.

This process might even include putting a fulltime overseer in these institutions to start trying to bring them under control.

Mr. **Silverberg**. I think, in addition to getting data from the Bank Board, I think it's necessary to really start an active dialog on whether the solution should involve merging the insurance funds or not, and I don't think, incidentally, merging the insurance funds is going to provide the financial resources.

I'm not even quite sure, perhaps the cessation of Texas would help, but I don't think that would do the trick either.

But I think that, realistically, you've got to start the ball in motion so that fairly early in the year, next year Congress addresses a rather massive program, and that program may involve a recapitalization of FSLIC. It may involve merging the deposit insurance funds.

But I think you need to get as many of the issues out on the table and debated between now and the end of the year so that Congress could actually get something done next spring.

Mr. **Greenbaum**. I think, Senator Graham, that the highest priority is to expedite the closure of the failed institutions. And whatever we can do in Congress to get that done, if it's cajoling the regulator, if it's providing greater supervision, if it's providing greater incentives to the regulator to move on that, I think that is the constructive thing that can be done in the interim.

That, together with fully laying out the dimensions of the problem so that the next Congress can address it forthrightly, I think those would be the high priority items on my list.

Mr. **Wolf**. Can I tack on one other thing?

FSLIC has, in fact, gone through and made an analysis, at least for the 200 and some cases that they have, of the cost for each one of them that they expect to incur.

I would think that the committee might want to keep fairly close contact with FSLIC as to the actual costs that they incur versus what they estimated, see whether those are beginning to diverge or not.

It's a kind of a way to keep track currently of what's happening.

The **Chairman**. Senator Karnes.

Senator **Karnes**. Thank you, Mr. Chairman.

I apologize for not being here earlier and hearing your formal remarks. And you may have discussed the issue of private capital, attracting additional private capital into the industry, already and, if so, we may be retracing ground that's already been covered.

But, how important is it at this point in time to look at putting some mechanisms in place, or looking at one of the options, to increase the opportunity for private capital to come into this market?

Some of you may be aware of the fact that I've introduced a proposal called the Thrift Charter Enhancement Act which would enhance the activities available under a thrift charter that would be done in conjunction with, a great concern for safety and soundness.

INCREASE THE OPPORTUNITY FOR PRIVATE CAPITAL

Mr. Greenbaum. I mentioned earlier that one of the more optimistic portents was that capital has been attracted into the industry through the conversions of mutuals to stockholder ownership and recently commitments of capital by notable nonfinancial institutions—the Basses, the Simon Group, the Ford Motor Co.

But, that becomes progressively more difficult if the successful INSTITUTIONS SEE THEMSELVES AS BEING HELD HOSTAGE FOR THIS ENORMOUS CONTINGENT LIABILITY OUT THERE.

If you're serious about attracting capital, you have to satisfy investors' preconditions to commit substantial sums. And if what they see out there is an unbounded liability to pay for the failed institutions, it's going to become progressively more difficult to attract capital. That's one reason why an expeditious resolution might pay a dividend.

Mr. Ely. Capital could be attracted if there was enough FSLIC assistance in these situations. But, private capital is not going to be invested in insolvent thrifts in a meaningful way unless FSLIC realistically covers the past losses in these insolvent thrifts.

Otherwise, investors would be throwing away whatever money they invested. But that, of course, then raises the question of where is FSLIC going to come up with all the money its should put into insolvent thrifts.

And that is the crucial issue here. Until such time as sufficient resources are made available to FSLIC to meet its part of the bargain, which is to basically bring the institutions up to a zero net worth, we are not going to be able to attract the capital needed to permanently capitalize the insolvent institutions so that once they are relaunched into the private sector, they will stay there.

I am concerned that in some of the transactions that have been announced, the newly invested capital is not going to be enough.

What we are doing in these cases is giving someone a highly leveraged opportunity. When some of these deals fail, as some of them will, FSLIC will have the institutions back in its lap, in a couple of years.

Mr. Silverberg. I think existing regulation is rather broad in terms of unitary thrift holding companies. So I don't think there are really significant barriers to nonbank institutions coming in and injecting private capital if the groundwork is appropriate.

There are restrictions on the bank side. I don't think those would dramatically change the scene, but I think those probably should be eliminated.

Mr. Ferguson. I don't believe that you're going to see any appreciable amount of investor capital available to come into the thrift industry, particularly in supervisory acquisitions, until the potential investors out there are convinced that the problem of the insolvencies and their effect upon the solvent ones are actually being handled in an expeditious way.

Senator Karnes. Let me also ask a question about the Federal Home Loan Bank System.

What role should the Federal Home Loan Bank System and its assets play in assisting in this issue of——

Mr. Silverberg. I could comment. You know, the $3 billion that's committed, up to $3 billion committed in the recap plan—in fact, I don't think the $3 billion will be needed, you know, in terms of buying $10.8, if they borrow the $10.8 in zero coupon bonds.

But, actually, within the Home Loan Bank System, there isn't all that much.

I mean, the $3 billion is roughly what's currently there in terms of reserves and undivided profits.

Now, there is a capital stock item on the balance sheets of the Home Loan Banks that amounts to roughly $12 billion.

You've got to appreciate that that item is on the asset side S&L's and savings banks.

To the extent that you confiscate that, you're taking away a big chunk of net worth of the existing institutions.

And so I think you've got to realize that once you dip into that capital stock, you are basically confiscating something that is owned by other institutions.

The Chairman. Senator Riegle.

Senator Riegle. Thank you, Mr. Chairman.

I want to echo a statement others have made, and that is for everyone within the sound or the reach of the reports from this committee today, that the insurance system behind the savings and loan system is sound and is in place today and will be tomorrow and will be in the future, that people's deposits in savings and loans up to $100,000 are safe. They will continue to be safe.

And as far as my view and my reading of the Congress and the administration, our Federal Government, that's written in stone.

So I don't think there should be any question or doubt about the strength of the Federal assurance that that money is protected and will be repaid when people go to take it back out again.

Having said that, I think it's clear that we've got a big problem here. And we may want not to recognize it for one reason or another; I think that's a mistake.

I think there's a big problem, and it's getting worse, not better. I think we face the need to do at some point, some kind of a major restructuring.

I don't think we yet know what that is; for myself, I don't tend to favor the idea of merging the insurance funds. And I doubt that we're going to get anything done of any consequence during the remainder of this administration.

And I say that because I think we're at the point now where the administration has more or less gone on automatic pilot on economic and financial policy issues. We see it with respect to the response to the recommendations of the Brady Commission. We see it on trade. We see it on Federal budget deficits. And, frankly, we see it here as well.

So I think, unfortunately, this problem is going to roll over and face the next President and, in fact, this Committee as well when we come back in the spring.

But, the problem's here today and we ought to be dealing with it now, despite the fact that I think there is an intention—in effect, what's happening is a large part of this problem's being papered over.

I think the estimates of the current insufficiency or loss that somebody's going to have to take is at the higher end of these ranges. As I talked with people and studied the problem over the last several months, I wish that were not so.

But I think it is. And I think that, at some point, unless we go in and solve the problem in the sense of dealing with the savings and loans that are underwater, cannot save themselves, and restructure the system, refinance it properly—I think cash and talent, as someone said, really are the keys to the future.

But we've got to have the right kind of structure. And the structure we have today I think is not getting the job done.

There are a lot of reasons why that's so and other special problems that have aggravated it, like real estate problems and energy area problems, and so forth.

Having said that, I'd like to pose one question, and that is this. And this sort of takes us down a different road than we've been on so far this morning. Why should Federal deposit insurance be put under any activity in a savings and loan that is not an activity that is authorized and approved in law by the Federal Government?

If the States want to add on and provide different kinds of operating authorities and activities and create a different kind of a playing field for savings and loans, why should the Federal Government deposit insurance and, in the end, the Federal taxpayer be on the hook for that kind of difference?

Why shouldn't we pull the deposit insurance back in and put it only under federally authorized activities?

And if the States want to add more, then find some other way to provide the deposit insurance for that additional activity.

Why wouldn't that make sense?

Mr. Ely, let's start with you and then we'll go down the line.

FEDERAL DEPOSIT INSURANCE

Mr. ELY. It would make excellent sense. During the entire existence of Federal deposit insurance, there's been a seldom-discussed moral hazard with it. And that is that the State regulators can, in effect, allow their institutions to take gambles with the proposition of heads, their State chartered institutions win; and tails, the Federal Government loses.

And so, although there has been much bowing over the years to the dual-chartering concept, dual chartering lost much of its justification with the advent of Federal deposit insurance.

The Federal Government, and thus the Federal taxpayer, is taking the risk; it ought to set the rules.

Mr. SILVERBERG. I generally agree, but I would want to point out that the Bank Board had the authority—for example, the Bank Board could have set its capital requirements at a level high enough, for example, that direct investment or equity investments be subtracted from regulatory capital for purposes of counting capital.

So, within the bounds of what the Home Loan Banks could do for the federally insured institutions, they probably could have handled some of the aggressive power——

Senator RIEGLE. Could have, but didn't, in your view?

Mr. SILVERBERG. Right.

Senator RIEGLE. Yes. Mr. Wolf?

Mr. WOLF. I would agree with that. I think much of the problem, in [illegible] could have been handled by the Bank Board if they had taken action early on with some of the problem things.

But there is clearly an issue there in terms of some of the States have let people go much beyond what's——

Senator RIEGLE. Well, how do you feel about that? I mean, why should we put Federal deposit insurance and the American taxpayer on the hook for those extensions of powers that States want to grant?

Mr. WOLF. I don't think we should.

Senator RIEGLE. Mr. Ferguson?

Mr. FERGUSON. I would concur. I don't think we should either. But I would also agree that I think the Bank Board did have the power to regulate around the State's right problem. However, I think this obviously involves a more basic policy issue that the Congress is going to have to address sometime.

Senator RIEGLE. Mr. Greenbaum?

Mr. GREENBAUM. Well, earlier, I mentioned the narrow bank proposal which is an extreme form of what you suggested. If we're going to have insured deposits, perhaps they should be fully collateralized with government securities.

This would eliminate virtually all risk in deposit insurance, and solve a whole host of problems.

The reason we didn't do that initially turns on considerations that stretch back to the 1930's, when they put the system together.

We chose to give banks the opportunity to place government-guaranteed funds at risk. We had certain protections in place at that time, but these have been eroded.

And so the worst aspects of the system have been magnified. Recall that we had the same system in the fifties and sixties with notable success. Right?

So something has happened in the seventies and eighties that has undermined the structure. We can, if we choose, go to precisely the kind of program you suggested.

Senator RIEGLE. Mr. Chairman, I just want to make one other comment before yielding, and that is this.

I think the dynamics of this problem are very complicated, but I think what's happening is that the desperately sick or failed S&L's are having the effect of damaging the entire system. They're harming the healthy S&L's. They're preventing them from—perhaps pulling them down into an equivalent situation, many of them.

I think it's damaging the rest of the banking system outside of the savings and loan system because of the upward pressure on interest rates. I think we're facing the prospect of higher interest rate pressure anyway. We've already seen that just in the last few days in the economy generally; that's a threatening additional development here.

But I would just make the prediction that although we've got no proposal to take any further action from the administration at the present time, that come January, in a new administration of whichever party—and this committee is going to have to take this issue up, I think, on an immediate basis.

I wish we could do it now in terms of the ability to face this problem squarely and fully, but—that says nothing about this committee, but I think the prevailing view today of the administration is that there's no real problem here. If it is, it's on its way to a solution, so nothing more is needed.

I think that's the wrong judgment. And time will show that to be the case.

The CHAIRMAN. Before I recognize Senator Sasser, Senator Garn has a unanimous consent request.

Senator GARN. Thank you, Mr. Chairman. I have a number of additional questions that are rather technical in nature on methodology and assumptions arriving at these figures. And rather than taking the time of the committee, I would just ask unanimous consent I'd be allowed to submit these questions to the witnesses and have them respond in writing.

The CHAIRMAN. Without objection, so ordered.

Senator SASSER. Thank you very much, Mr. Chairman.

Mr. Chairman, I have a statement that I'd like to have included in the record.

The CHAIRMAN. It will be included in full in the record.

[The prepared statement of Senator Sasser follows:]

STATEMENT OF SENATOR JIM SASSER, SENATE BANKING COMMITTEE, MAY 19, 1988

MR. CHAIRMAN, THANK YOU FOR CALLING THESE IMPORTANT AND TIMELY HEARINGS ON THE CONDITION OF THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION. AS YOU KNOW, I HAVE IN THE PAST, ON THIS COMMITTEE AND OTHERWISE, BEEN A VERY STONG SUPPORTER OF THE INDEPENDENT THRIFT INDUSTRY. INDEED, SAVINGS AND LOANS HAVE BEEN ENORMOUSLY IMPORTANT IN EXPANDING HOMEOWNERSHIP OPPORTUNITIES FOR MILLIONS AND MILLIONS OF AMERICANS.

HOWEVER, MUCH OF TODAY'S TESTIMONY IS DISCONCERTING. IN PARTICULAR, THE WIDE RANGE OF ESTIMATES OF THE SCOPE AND THE COST OF THE FSLIC PROBLEM WILL GIVE US PAUSE.

MR. CHAIRMAN, I DON'T THINK MANY OF USE WHO SUPPORTED LAST YEAR'S BANKING BILL AND THE FSLIC RECAPITALIZATION CONTAINED THEREIN THOUGHT WE WERE THROUGH WITH THIS ISSUE. ON THE OTHER

HAND, I FOR ONE CERTAINLY DIDN'T EXPECT IT TO RAISE ITS HEAD AGAIN SO QUICKLY AND OMINOUSLY.

INDEED, IT IS POSSIBLE THAT THE PROJECTIONS ARE INCORRECT. HOWEVER, IT IS AN ISSUE THAT DESERVES VERY CAREFUL STUDY. I LOOK FORWARD TO TODAY'S TESTIMONY. THAN YOU.

Senator **Sasser**. Mr. Chairman, as I understand it, these witnesses have testified here this morning that the liabilities of FSLIC range anywhere from $30 billion to $64 billion at the present time.

That these liabilities are going to get worse as time goes on. Now, the question comes: How in the world did we get in this sort of situation?

On page 3 of your statement, Mr. Wolf—and you make a strong statement—you say, and I quote:

> Diversification into riskier activities, high cost of funds, and insufficient supervision coupled with severe economic downturn in certain sectors of the economy have left many thrifts with little except enormous losses from their poor quality assets.

What role did diversification into riskier activities play? And in particular, what role did deregulation play, in your judgment? Would we have been better off or worse off without expanded powers for these threats?

THE ROLE OF DEREGULATION

Mr. **Wolf**. I'll take a crack at that. I'm not sure that I would say we have been better or worse off in the aggregate for the industry. The problem is that significant portions of the industry got into much higher risk transactions than lending money to you and to me for our homes.

Senator **Sasser**. As a result of deregulation.

Mr. **Wolf**. As a result of deregulation, policy decisions, State charter actions, et cetera. There were a number of reasons and a number of things that permitted that.

Senator **Sasser**. Well, just continuing on with the same thought, your GAO report indicates that the thrift industry's holdings of mortgage assets have declined from 80 percent of total assets in December 1977 to 69 percent in June 1987.

And over this same period, nonmortgage assets have increased from 14 percent of total assets to 30 percent of total assets, almost, well, over 100 percent.

Again, over the same period of time, from December 1977 to June 1987, the number of insolvent thrifts increased from only 14 in December 1977, which represented three-tenths of 1 percent of the industry, to 491 thrifts in June 1987, or 15 percent of the industry.

The report also indicates, your report, that insolvent thrifts have, "consistently held fewer mortgage assets as a percent of total assets than have the higher net work risk."

What are these numbers and what are these statements telling us? Are they telling us that those institutions which really got in trouble are those who shifted away from their traditional business of mortgages, shifted away from mortgage lending and got into the high-risk stuff. And that's how they essentially got in so much trouble?

Mr. **Wolf**. Yes. [Laughter.]

Senator **Sasser**. That's what I call a succinct answer to my question, Mr. Chairman. [Laughter.]

Does anybody want to amplify on that to some extent?

I bring this up because there are those of us who worship at the altar of the free market, the open market. And they say that's the solution to all of our problems.

And they're urging more deregulation on us in the banking industry. And I just think we ought to listen to some of this and perhaps learn from a little history here.

If, indeed—and I don't want to put words in anybody's mouth—but if, indeed, deregulation was a significant factor, if not the single proximate cause, at least a significant factor in what's happened to these thrifts—who wants to amplify on that?

Mr. Wolf. Could I add one comment to that?

Senator Sasser. Yes, Mr. Wolf.

Mr. Wolf. The other problem with that is that we did not have a regulator that was taking forceful action to watch over some of this. They didn't have the people to do it or the expertise.

That's if we let people do things like that, one of the things that's got to be there is a regulatory apparatus to follow up on what's happening.

Senator Sasser. But, many of us have made this point in times past. You can create the form of a regulatory apparatus, but you can't create the substance of it overnight. That takes personnel, skilled personnel.

And I fear that we may be repeating this same error in other ways.

Who wants to——

Mr. Greenbaum. May I respond, Senator?

Senator Sasser. Yes, Mr. Greenbaum.

Mr. Greenbaum. I think it may be something of an oversimplification to point to deregulation as the ultimate cause. That was a piece in the mosaic, without a doubt.

But what we had here were institutions that were stripped of their capital because of the inflation of the seventies and the inversion of the yield curve in 1980 and 1981.

So we had many institutions out there who no longer had their own capital in the business. Their attitudes toward risk-taking were transformed by that experience.

And to compound matters, we had the marvelous success of Wall Street, Freddie Mac, and Fannie Mae in securitizing mortgages that brought their yields down substantially.

Deposit costs went up further squeezing the spread, so that traditional intermediation between deposits and mortgages no longer could sustain an institution. You simply couldn't pay your overhead doing that any more.

So you had a variety of forces bearing on this issue that pushed institutions to process riskier assets.

Deregulation permitted some of this to be accelerated, but I think you have to look to underlying forces.

Senator Sasser. Just let me follow up on Mr. Greenbaum's testimony just a moment.

Would not the whole problem be significantly smaller had it not been for the deregulation? In other words, I'm aware of the fact that you had thrifts in trouble as——

Mr. Greenbaum. I'm not confident of the answer. All I can say is perhaps, because I think that these processes are, to a certain degree, endogenous. The behavior of the regulator is influenced by the industry.

And there was an effort to permit savings and loans to expand into new activities before legislation sanctioned that.

In the early eighties, the regulator was interpreting the regulations as liberally as possible before the deregulation was sanctioned by legislation.

I think you have to look to the fundamental motivating forces rather than to the legislation. Now, let me add that, to the extent that the Government maintains its position as a guarantor of the system, it has every right and obligation to circumscribe the activities of these institutions.

And I don't want to soft-pedal that. If you're in a private insurance business, you retain the right to write covenants and restrictions into insurance contracts. Congress, as a guarantor, has that same obligation or right on behalf of the public.

Senator **Sasser**. Mr. Silverberg?

Mr. **Silverberg**. If I were to rank all of these considerations, I would rank higher than deregulation by a considerable margin the behavior of the regulator.

The regulator during this period, just following on what Mr. Greenbaum said, basically encouraged growth. There was an active reduction of capital requirements in order to facilitate growth.

The notion was that somehow because of the interest rate problem, the way to handle that problem was to get very big very quickly and put new money on the books.

And, basically, a very big chunk of the problem I would lay at the doorstep of the past two administrations of the Bank Board, where growth was strongly encouraged and capital standards were not enforced.

The **Chairman**. Would the Senator yield just for a clarification? In your response to that question, would you put a time period on that regulation? We've had several regulators. We now have a regulator——

Mr. **Silverberg**. OK. That seems fair. I'm basically talking about a period probably runs between 1980 or 1981 and 1985. Probably, if I would focus more on a particular administration, it probably might have been more in Mr. Pratt's term and the early stages of Mr. Gray's term.

I think at the later stages, Mr. Gray saw that there was some wisdom in capital requirements, though they were not enforced consistently.

Mr. **Ely**. I think we have two issues here.

First of all, deregulation, per se, was not bad. What was deficient at that time was not reforming the deposit insurance process to build risk sensitivity into it. To reflect the greater heterogenicity now permitted among thrifts. That, of course, is the entire direction in which the financial services industry is moving.

Another even more basic consideration is that we are starting to see the limits of the efficacy of the regulatory process. The physical world is full of limits; so, too, is the regulatory world.

As we look at this problem from a long-term perspective, we have to say that the regulator can only do so much. Beyond that, we have to look to other mechanisms.

The mechanism that we have to look more in the future is the pricing mechanism itself. In effect, pricing is a much more effective regulator than the regulatory agencies themselves.

Senator SASSER. Mr. Wolf, do you think the Bank Board is doing a better job as a supervisor-regulator?

Mr. WOLF. Better than? [Laughter.]

Senator SASSER. Just leave it at that. Do you think it's doing better than what preceded it?

Mr. WOLF. I think there has been a recognition that the Bank Board for the last probably 2, 2½ years, clearly, has a major problem. They've been trying to deal with it.

I think they're on the track to trying to resolve some of these problems. Whether that's going to be successful or not, as I said, still, we will have to see.

Senator SASSER. Mr. Chairman, I know my time's expired. If I could just ask one other quick question of—a really almost parochial nature?

The CHAIRMAN. Without objection, go right ahead.

Senator SASSER. In the western part of my State, western Tennessee, which abuts up not too far from Texas, there's a real problem about high rates being paid on deposits by failing or near failing thrift institutions in the Southwest. Banks and thrifts in my State complain of a rate war.

They have to pay more on deposits because they have to compete with the high rates offered by these failed institutions, or institutions that are on the verge of failing, that are being kept open by the FSLIC.

How extensive is this problem and what does this do about exerting upward pressure on interest rates nationwide?

Do you want to tackle that, Mr. Wolf?

FAILING INSTITUTIONS AND HIGH RATES ON DEPOSITS

Mr. WOLF. It's a problem. It is a problem not just in your State, it's an across-the-board problem. And it argues for dealing with these problem institutions, the insolvent ones, as fast as we can because that's one of the benefits we'll get, is if we get those institutions closed, then we may minimize some of that upward pressure.

Mr. FERGUSON. I would agree it's been a United States-wide problem for some time.

I think that the best solution to it is to try to close the insolvent thrifts. And then I think that, by the time that is done, you may be able to analyze the solvent thrifts and reach a more favorable conclusion as to their health and future and viability than you can today.

Mr. ELY. What we have today are a number of institutions that are, frankly, nothing more than ponzi schemes in that they are having to attract deposits at any price to keep their doors open.

Without this increase in deposits, they could not do that. And so they enter into rate competition, and that is what is raising interest rate levels across-the-board. Until these insolvencies are dealt with by putting in a lot of cash to pay off the depositors and shrink the amount of intermediation we have in the economy, this problem is going to continue.

Mr. SILVERBERG. I agree with you basically, yes.

I just want to add one thing. In a number of instances, institutions have been taken over by the Bank Board with the MCP program and what not, and they walk in and they continue to pay these extraordinarily high rates in order to fund these institutions.

It's a very serious problem. And I indicated earlier I think the single thing we could do to ameliorate the situation, the single most important thing that we can do in the short-run, is to close as many of these failed institutions as we can.

And a major benefit will be to reduce this kind of destructive competition between potentially viable institutions and institutions that are not viable.

Senator SASSER. Thank you, gentlemen.

The CHAIRMAN. I take it there's no sentiment here to reinstitute something like regulation Q, some kind of a cap on the interest they could pay?

Because it does seem absurd that these institutions can pay whatever interest they want and of course it's insured up to $100,000.

Mr. GREENBAUM. Doubly absurd if it's the Home Loan Bank that's running the institution.

The CHAIRMAN. And they're still paying the interest rate——

Mr. GREENBAUM. Yes. Yes. Yes.

The CHAIRMAN. Mr. Wolf, I'd like to ask you, the League of Savings Institution, the U.S. League, wrote to the Comptroller General to complain that they're being discriminated against by your organization in two ways.

First, the letter claims that the FDIC audit does not include an item, and I quote not, "provision for loss contingencies, because such estimates depend on factors which cannot be assessed until after the bank is actually assisted or closed."

The FSLIC audit, on the other hand, does include such an item. So that there's discrimination there against the savings and loan compared to the banks.

Will you respond to that charge?

Mr. WOLF. We have, in fact, written a letter to the U.S. League explaining exactly what we do in the audit and explaining that there is not an inconsistency, that, in fact, in the FSLIC audit, we look at the cost for institutions that are hopelessly insolvent and have been either taken over or managed or are under active supervision by, in this case, FSLIC.

The point is that FDIC——

The CHAIRMAN. When did you write that letter?

Mr. WOLF. I've got a copy of it here. Within the last 3 or 4 weeks.

The CHAIRMAN. Will you submit it for the record?

Mr. WOLF. I would like to submit it for the record.

[The documents follow:]

GAO

United States
General Accounting Office
Washington, D.C. 20548

Accounting and Financial
Management Division

May 11, 1988

Mr. William B. O'Connell, President
United States League of Savings Institutions
111 East Wacker Drive
Chicago, Illinois 60601

Dear Mr. O'Connell:

Your April 27, 1988 letter to the Comptroller General speculates about the results of our ongoing audit of the Federal Savings and Loan Insurance Corporation's (FSLIC's) 1987 financial statements and raises concerns about what you consider to be GAO's use of inappropriate procedures to conduct the audit. FSLIC's 1987 financial statements have not been finalized nor is our audit complete. Accordingly, the final results of FSLIC's 1987 operations and our audit are not yet available. Regardless, your criticism of our procedures is simply inconsistent with the facts.

First, in regard to your comment that GAO will require FSLIC to increase its "reserve for contingencies," it is important to recognize that the management of an entity being audited and the auditor have separate and distinct responsibilities. Management is responsible for preparing financial statements accurately and in accordance with appropriate accounting principles. The auditor is responsible for examining and attesting to management's assertions that the statements fairly report an entity's financial condition and results of operation. Although the auditor may recommend adjustments to accounts, changes in accounting methodology, or additional disclosures in the footnotes, the financial statements belong to management and it must decide to accept or reject such recommendations. The auditor cannot force management to change the statements but, if certain matters are not satisfactorily resolved and significantly affect the fair presentation of the financial statements, the auditor may appropriately qualify his audit report.

Moreover, for financial statements to be meaningful and permit comparisons between different time periods and organizations, they must be prepared according to a common set of standards. Government corporations, such as FSLIC, prepare their financial statements according to Generally Accepted Accounting Principles, while federal agencies prepare financial statements in accordance with Generally Accepted Accounting Principles for Federal Agencies. Both sets of standards require accrual basis accounting, not cash basis accounting as suggested in your letter. Accordingly, the standards require recognizing losses when they are incurred, regardless of whether payments to cover such losses are made at a later time.

Your letter also suggests that a reserve for losses is not appropriate for FSLIC because such losses are contingent in nature and not reasonably estimable. This is not correct. The reserve for 1987 is primarily based upon the caseload of insolvent institutions that district bank supervisory officials have turned over to FSLIC because resolving the institutions' problems requires FSLIC's financial assistance. Such institutions are often termed "FSLIC cases." FSLIC and district bank supervisory personnel, who are experienced in resolving problem institutions through liquidations and mergers and quite familiar with the costs involved in such transactions, develop estimates of the costs involved. This approach is consistent with the method FSLIC used to calculate its 1986 reserve of $10.5 billion. We would also like to emphasize that the term "contingent" in no way applies to these cases. They represent losses that FSLIC has incurred and will ultimately have to fund. The fact that, as your letter points out, FSLIC cannot resolve all of them for several years, does not diminish FSLIC's liability. Instead, delaying resolution means that FSLIC's ultimate costs may increase as these institutions incur further losses.

Your letter also states that GAO audits the Federal Deposit Insurance Corporation's (FDIC's) financial statements against a different set of standards than those used for FSLIC's statements. This is not correct--the statements of both organizations are evaluated for conformity with Generally Accepted Accounting Principles. The two organizations' financial statements show vastly different results because of their relative financial health, not because of inconsistent application of accounting principles. Essentially, FDIC does not provide an allowance for failed but operating institutions because FDIC does not have the equivalent to FSLIC's caseload of failed institutions that are permitted to continue operating for indefinite periods. However, each year our audit of FDIC carefully considers whether FDIC needs to establish a reserve for losses related to failed but operating banks. Thus far, we have not found a reserve to be necessary. Should we find in the future that a reserve is needed, you may be assured that GAO would suggest that FDIC provide one, just as GAO has with FSLIC.

In regard to funds available to FSLIC in the future, your letter correctly points out that the Competitive Equality Banking Act of 1987 (CEBA) authorizes FSLIC to raise up to $10.8 billion in additional funds. As you know, these funds are to be raised through the sale of bonds to the public, and the interest on the bonds will be paid from FSLIC's future assessment income. Consistent with appropriate accounting principles, FSLIC's financial statements should reflect the amounts it actually receives through the bond sales--not the amounts it potentially may raise nor the associated future interest costs. The amounts of funding available to FSLIC over the next several years will depend upon a combination of factors including the amount of bonds actually sold, interest rates required to generate the sales, the extent to which special assessments continue, the industry's deposits, and economic conditions. Therefore, while it is unacceptable for FSLIC to include potential future income in its financial statements, you may be assured that we will carefully consider future financial resources potentially available to FSLIC in formulating our opinion on its financial statements.

As your letter points out, FSLIC can also raise funds through the sale of assets obtained from liquidated institutions. However, your belief that FSLIC is not receiving credit for these assets is mistaken. The value of such assets is appropriately reflected in FSLIC's financial statements as "subrogated accounts from receivers" and, therefore, represents an available financial resource.

Finally, we want to emphasize our belief that the industry and the public are best served by full, open, and fair disclosure of FSLIC's financial condition. Previous attempts to deal with the industry's problems by masking or minimizing them through so called "regulatory accounting principles" have not been productive. Instead, they tended to postpone recognition of the problems, and thus the actions needed to resolve those problems. For the thrift industry, it is abundantly clear that such delays have been most costly. We do not wish to compound that cost by condoning invalid accounting principles for the industry's insurer.

I hope that this letter has cleared up the misunderstandings you had about our audit of FSLIC's 1987 financial statements and the basis of accounting followed by government entities in reporting their financial condition. Please contact me if you have additional questions.

Sincerely yours,

Frederick D. Wolf
Director

Mr. Wolf. We do not think there's an inconsistency. The difference relates to the fact that the circumstances of FDIC and FSLIC are vastly different. FDIC has the resources and has taken the actions to close institutions when they become insolvent.

FSLIC has not been able to do that. And, therefore, we have, in effect, warehoused all of these cases which are insolvent and where we know we're going to have to deal with them.

So the difference is not accounting; the difference is facts.

The Chairman. Mr. Ely?

Mr. Ely. I would disagree with Mr. Wolf to some extent. The only deposit insurance fund that properly accounts for its future losses is the third one that we haven't talked about today, the National Credit Union Share Insurance Fund.

For over 5 years, it has put a reserve on its balance sheet for its expected cost of case resolution in the credit unions that it knows are in trouble.

And I might add the Share Insurance Fund is the only one of the three deposit insurance funds that gets a clean opinion from a major private sector accounting firm.

In my opinion, the FDIC and the FSLIC could do the same. The FDIC has said in its footnotes it can't be done. I disagree because the Share Insurance Fund does it.

But, the thing that is important here is that had FDIC and FSLIC created loss reserves and had there been rigor in estimating insolvency losses as they were growing, I think a lot of the debate that we're having now would have been held 2 or 3 or 4 years ago when the cost of resolution would be a lot lower.

So, again, it comes back to the point that we need better information and more complete information as to how big the problem is.

Part of that task is getting better loss estimates on the balance sheets of the deposit insurance funds.

The Chairman. Now, the second complaint made against the GAO by the League is that:

While the GAO anticipates FSLIC's future expenditures, it does not anticipate its future revenues.

So it causes it inaccurately to appear to be insolvent. The League letter claims that GAO's practice is not only at odds with the cash accounting that is common to the Federal Government, it causes real economic damage because it raises the industry's cost of funds.

Mr. Wolf. Again, we commented rather extensively in our response on that, which I'd like to submit for the record.

We are not imposing on them accounting standards or rules of reporting that are any different than we follow for all government corporations. We do not recognize future revenues, nor does any accountant recognize future revenues in the financial statements.

But, clearly, when we look at the availability of funds and resources to deal with the problem, as we've done when we look at the outlook for FSLIC, we have included those recap funds in there as one of the elements.

So I don't think we're being unfair to them at all.

The Chairman. Mr. Ely?

Mr. Ely. The reason you don't include future revenues is because they're not there yet; but the past losses are. So only the losses should be counted and not the future revenues.

The **Chairman.** Anybody dispute that?

Mr. Greenbaum. Yes, I dispute that. As long as you stay in the game, the market can change and those losses will change, too. Just as the revenues are anticipated, there's an expectation of losses. They're both uncertain.

So I don't think that distinction holds.

The **Chairman.** Sounds like a pretty good rebuttal to me.

An expectation on both sides? Mr. Silverberg.

Mr. Silverberg. Yes, I think I would look at it differently. Clearly, you've got a current expected value in terms of the losses of those institutions. In fact, I'd argue that it's probably, substantially understated.

But, if you're looking at revenues down the road, there's the question of what about future failures?

You've got to project something offsetting on that side.

And of course there is the interest on the FICO bonds, which are not booked as a liability? It seems to me that is a very clear-cut liability and Congress wrestled with this in the recap program.

The present value cost of paying that future interest is there and probably ought to be booked.

The **Chairman.** Thank you, Mr. Silverberg.

Senator Riegle.

Senator **Riegle.** Thank you, Mr. Chairman.

I think this has been a very helpful set of witnesses today in the testimony they have given us.

I would like to make one other brief comment and then ask a final question for my part.

I think we need the savings and loan industry. I think it serves a very valuable purpose to the country. I think it needs to be strong and solvent. It needs major work to move it to that point.

I think that the industry is struggling today. It is in real difficulty. I mean, there are some S&L's that are able to do well, but I think that those that are not and those that have essentially failed are each day damaging those that are still there that are trying to get ahead and to do a good job.

So, this is a problem that we are going to have to deal with, and I just wish we could get at it in a full-blown way now rather than to have to take it up with a new administration next January.

But because that's the way it looks, I would like to ask each of you this:

If we assume that we stay basically on the track we are on today, no major structural changes and the efforts that are now being made to chip away at the problem continue and we roll the clock ahead to January 1989, roughly 6 or 7 months, I would like to know what each of you thinks you would be prepared to recommend at that time to a new administration as to what needs to be done in terms of really coming to grips with this set of problems. And I am talking about a nice compact picture as you can give us in terms of what you think the scale of that problem is likely to be and what it's going to take to really hit it head on and deal with it from the timeframe of January 1989.

Mr. Ely, why don't you start?

RECOMMENDATIONS FOR THE NEXT ADMINISTRATION

Mr. ELY. I think the key thing the next President has to do is recommend that the big hit be taken quickly. We have a classic turnaround type of situation where nothing is to be gained by delay. However big the problem is today, it's going to be $7 billion to $10 billion bigger by early next year.

I think that without question this resolution is going to require general taxpayer funds, unless there is a massive seizure of private sector bank and thrift capital.

Given that, I think the next President should recommend a program that is going to entail spending probably at least $40 billion of taxpayer money, and it is money that has to be spent quickly. What we will do is put onto the Federal Government's balance sheet a portion of the national debt that already exists in the form of the accumulated insolvency losses in these institutions.

The reason to do this and the economic benefit of doing it is to reduce the cost of interest on this portion of the national debt and to eliminate all of the distortions caused by allowing insolvent thrifts to continue operating. These distortions include the economic resources that these insolvent institutions are wasting and the additional interest cost burdens that are being placed on the healthy institutions.

Thus, we need to deal quickly with the FSLIC situation not only to dispose of the sick thrifts, but to end their drain on the healthy portion of the thrift industry. We don't want to pull down the healthy players along with the sick thrifts.

Senator RIEGLE. And your estimate is that roughly the liability at that time is likely about $70 billion if you tack on the $7 billion of your figure of today of about $62 billion or thereabouts?

Mr. ELY. I think that's the case because by my calculation FSLIC's accumulated insolvency loss is compounding at the rate of 15 percent a year, and possibly more than that.

FSLIC's accumulated insolvency loss is like a big mortgage on which we are not even covering the interest on it through FSLIC case resolutions.

So, the loss just keeps piling up and up and up. It's like the oil filter ad, "Pay me a lot now or pay me more later."

Senator RIEGLE. Mr. Ferguson?

Mr. FERGUSON. I don't know what the loss is and, quite frankly, I don't think anybody else does at this particular point in time. But it obviously is large and significant to this country and to its taxpayers.

I do think that the key to it is to get it contained early on in the next administration, identify as much of the problem as you can, give it the human resources and financial resources to go ahead, and let's take our hit, get it behind us, and I believe the effect will be that this country will have a stronger financial system as a result of it.

Senator RIEGLE. Do you envision that, then, as encompassing some sort of major restructuring in order to sort of get current on this problem?

Mr. FERGUSON. I don't know that it would take a restructuring, but you obviously have a large number of S&L's that you have to deal with, of insolvent thrifts.

And I strongly suggest you will have more of them or maybe as many of them at least at year-end as you have now, because I think that, as the testimony here today has clearly demonstrated that this panel is in basic agreement, we haven't seen all the insolvents yet that we're going to have.

Senator RIEGLE. Well, and the tide is running the wrong way.

Mr. FERGUSON. Yes.

Senator RIEGLE. It's not running with us, it's running against us.

Mr. FERGUSON. Yes, it sure is.

Senator RIEGLE. Mr. Wolf, let's go to you and then Mr. Silverberg and then Mr. Greenbaum.

Mr. WOLF. I guess the basic thing——

Senator RIEGLE. What I am looking for is what is it going to take come next January, what do you foresee?

Mr. WOLF. It's going to take the resources in terms of people and actions to close the problem institutions. That's the first thing that's got to be done. And probably a very clear commitment again by a new administration that this problem is going to get solved and the Government stands behind that insurance program so that we've got the time and the resources to carry out the solution.

Senator RIEGLE. Mr. Silverberg?

Mr. SILVERBERG. Yes. I think it's got to be addressed early. There has got to be some decisions made on future failure management policy that doesn't compromise supervisory standards.

I think that we've got to look at future capital standards. We've got to look for growth restrictions for undercapitalized institutions, probably some transition rules for those that barely make it. And I think we have to look at the options of trying to deal with these problems either as a separately capitalized FSLIC or perhaps a merger of the insurance funds.

Senator RIEGLE. Mr. Greenbaum?

Mr. GREENBAUM. I think we have to close the failed institutions. That is absolutely critical.

But let me add something because there was a statement made to the effect that we should spend money quickly. We have to be very careful. Once you loosen the financial resources constraint, you then bump into another constraint: the ability to deal with cases within the regulatory agency, the competence and the number of people.

It won't do us any good to throw money at the problem if we don't have the human resources in place in the regulatory agency. This is a hidden constraint now because the binding one is the money. We will have to take a very careful look at the structure of that agency, how it's run, how it's managed, how it's staffed.

The other thing I think is terribly important for us to examine in January is the deposit insurance system. That is, do we want deposit insurance; if so, in what form? And this question applies to the banking situation with equal force.

That is the bread-and-butter question that we will need to address if we are serious about correcting the structural problems we have today.

Senator RIEGLE. Yes.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator D'Amato?

Senator D'AMATO. Mr. Chairman, I am taken by Mr. Greenbaum's last statement as it relates to deposit insurance. I think that he raises a very significant question.

I also think it is rather interesting to put forth the proposition that somehow you're going to begin to rate insurance for those well-managed and premiums-paid institutions as opposed to those poorer. You start raising the premiums on those that are poorer, you're just going to exacerbate the problem and put them out in any event. So, I think that's oversimplistic, to be quite candid with you.

Mr. Wolf, you make some observations about the failed institutions, that in addition, you bring up the question of dishonest operators in the market.

I would like to ask you what you propose as a solution and how you undertake dealing with that and what specific regulatory supervision do you feel is required to deal with those situations?

Mr. WOLF. I am not sure I can give you a formula for how you ferret out crooks in any area before they have begun their crooked activities.

Senator D'AMATO. Well, we understand that now. Come on. That's a lesson of life. I mean, that's fantastic.

Mr. WOLF. I am not sure where you go beyond that other than to say that the regulators have got to be looking for signs of deterioration in all of the institutions they are looking at, looking for some signs of imprudent lending, concentration to one borrower, poorly collateralized or potentially even with fraudulent appraisal-type information. Those are things that a regulator has got to look at when they go in and look at an institution.

I don't know any other way you do it.

Senator D'AMATO. Mr. Greenbaum, do you think we have sufficient capability as it relates to these areas to undertake that?

Mr. GREENBAUM. You're talking now about reining in the problem of potentially dishonest behavior?

Senator D'AMATO. Not only dishonest, but those activities that are obviously imprudent.

Mr. GREENBAUM. We have twisted and distorted the incentives of the manager-owners of these institutions encouraging them to engage in high risk activities.

Now, the interesting thing is that we did not have this problem, by and large, in the 1950's or in the 1960's. So, something happened in the interim that changed the nature of those incentives.

Senator D'AMATO. Deregulation, regulation Q.

Mr. GREENBAUM. No, no.

Senator D'AMATO. No?

Mr. GREENBAUM. Those were proximate in their influence. But there are deeper issues. We stripped away most of the capital of the industry. Enormous losses were sustained. Owners were left with little of their own capital at risk. Consequently, this colored incentives and behavior, and we have reaped that whirlwind.

From 1950 to 1970, we had on the order of eight failures a year in the banking business. And probably two-thirds of those involved felonious behavior. That means we had five or six such cases a year out of a population of 14,500 institutions. That speaks very well of the industry.

Bankers wore belts and suspenders, and every piece of bank architecture had columns, and these are all related. They're related because these institutions were massively subsidized and it was understood that if they did not behave, they had a great deal to lose. At stake was their charter, and the charter had value because it permitted thrifts and banks to borrow at heavily subsidized interest rates. This was the franchise, and they had to protect it.

Senator D'AMATO. My time is up, but would you—I will just, Mr. Chairman, conclude—what has changed? What has brought us to this? What do you see as the significant change?

Mr. GREENBAUM. In the 1970's we had a sustained inflation. That opened up a large spread between market rates of interest and the rate-constrained deposit interest rates that the banks and thrifts were offering.

The clientele rebelled. They created money market mutual funds. They withdraw their deposits, and the money market mutual funds obligingly returned the funds to the bank or thrift, but in rate-unconstrained deposits. All that happened to the banks was that their cost of funding went up.

Now, to add insult to injury or to add injury to injury, 1980–81 brought an inversion of the yield curve that took about half the remaining capital out of the thrift business. In 18 to 24 months they lost about half of their net worth.

We ended up with a bunch of paupers running these institutions, and they behaved like the disenfranchised would be expected to, it seems to me. And that needs fixing.

Senator D'AMATO. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Ely, did you want to comment on the Senator's question?

Mr. ELY. The world has changed permanently, and we are never going to be able to go back to banking and thrift environment of the 1950's and 1960's. Why has the world changed? First of all, markets work much more efficiently today. The reason that the system worked then is that savers didn't have the opportunities and options that they have today. In effect, low, fixed interest rates paid to savers were on savers in earlier decades.

The second thing is that technology has dramatically changed conditions. Thus, banking and banking-like activities can no longer be isolated from the rest of the economic system by the regulatory process as was the case 10 or more years ago.

I am afraid the genie is out of the bottle. We cannot expect to go back to those times, specifically by trying to put reg Q back in place. There are too many ways today to evade it. I think we have to recognize that we are dealing in a permanently changed world. We have to respond accordingly.

The CHAIRMAN. Gentlemen, I want to thank you very, very much. This is not only an excellent panel, highly competent and—I don't think I have ever used this term with respect to an entire panel of five witnesses—but I think it is a brilliant panel.

I think your testimony this morning has been extraordinarily useful. It has certainly given me an insight, and I think other members an insight into the problem we didn't have before, and a very useful insight.

Thank you very much.

The committee stands adjourned.

[Whereupon, at 12:35 p.m., the committee was adjourned.]

OVERSIGHT ON THE CONDITION OF THE FINANCIAL SERVICES INDUSTRY

WEDNESDAY, MAY 25, 1988

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m. in room SD-538, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Riegle, Dixon, Sasser, Shelby, Graham, Garn, Hecht, Gramm, Bond, and Karnes.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The committee will come to order.

Eleven years ago this committee held the first of its annual hearings on the state of the banking industry. We held those hearings because we were concerned about indications that conditions in the banking industry were deteriorating.

We noted, for example, that the number of bank failures had been rising and there were more and larger problem banks. The banks were exposed to losses on their LDC loans and the industry in general was undercapitalized.

We were right to be concerned. Today we worry about similar kinds of problems, but some of these problems are even greater today than they were in 1977.

In 1977, six banks with $¼ billion in assets failed, whereas last year 203 banks with $1½ billion in assets failed.

Let me just interrupt to say that the staff wrote that. I'm not quite that concerned because we have to recognize we have 14,000 banks, that banking still has probably the best record of any industry in America in the percentage of failures given the numbers, and of course the situation has changed dramatically in many, many ways since 1977. Nevertheless, I think we should consider these numbers.

In 1977, there were 368 troubled banks with $62 billion in assets. Last year, four times as many banks with four times as many assets were given CAMEL ratings of 4 or 5.

In 1977, we were concerned about foreign lending, particularly by our largest banks. More recently we have been worried about problems in the energy, agriculture, and real estate portfolios of banks and LDC debt is still with us.

However, the picture this year is by no means all gloomy. We have made progress. Primary capital ratios have increased by 21 percent since 1977. International agreement to implement risk-based capital has been reached. We have turned the corner on some of the regional problems.

I've called today's hearing so that our bank regulators can bring this committee up to date on the condition of our banking system. We have a distinguished panel of witnesses. I look forward to your testimony.

Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

As everyone knows, last week we focused on the problems of the thrift industry and today we are looking at the condition of the banking industry and its supervision.

I think everybody is well aware that the situation is much better in the banking industry than it is in the thrift industry. Certainly the FDIC has much larger resources and is in better shape than FSLIC.

However, there still have been a record number of bank failures and difficulties within the system. Although LDC debt has been improving, it is still a major problem. Even though the banking system is in better shape than the thrift industry, it's certainly something that we still have to maintain a very watchful eye on. I would like to commend the regulators, for the way it has been managed under these difficult conditions. I doubt if 10 or 15 years ago that anybody could have envisioned the problems in the agricultural or the oil sector. Who knew that we would have such large numbers of failures in both the thrift and the banking industry and yet have no major runs or panics. I think most people would have anticipated that by looking at past history.

I think that under difficult circumstances it's been well managed and continues to be well managed. We must recognize that we still have some serious problems. We must be very careful, not only on the regulatory side, but also here in Congress, by staying aware of those problems, keeping on top of them, and making sure that they continue to be handled in the proper manner.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Riegle.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. Thank you, Mr. Chairman.

Let me welcome our witnesses today. I have three items that I'd like to have you address in the course of your comments and responses today.

First of all, as has been mentioned, we've had a hearing here recently on the savings and loan problem and we have a very serious problem with the insurance fund that is not adequate and we are told that the losses as yet unrealized are mounting and that the way the mechanics of the industry work it has tended to drive up interest rates as savings and loans that are in trouble have to go out and with interest rate premiums attract capital to keep the doors open.

I'm wondering the degree to which that problem is spilling over into the banking area in the sense that we are seeing upward pressure on rates that is maybe having a harmful effect on just the overall ability of banks to be profitable, raise capital, increase their capital strength and so forth.

So I would like to have your sense for the cross connection of the S&L problem to the commercial banking sector.

Second, I'd like you to give us an indication of any plans any of you may have with respect to further regulatory decisions on banking deregulation this year. And I raise that because as you know this committee has acted just about exactly on the date of the expiration of the moratorium and the Senate as a whole has acted by an overwhelming numbers and we have sent a comprehensive financial institutions deregulation bill over to the House. The House has a different jurisdictional setup and they're working their way through that issue, and are not as far along obviously as we are, but I fully expect that before the year is out that we will see action in the House. It is my hope that we will and that we will go to conference and produce a bill that will lay out the future of the financial services industry in this country in an orderly way and do it by changes in law that are done out here in the open and in full debate and with votes and finally a presidential signature. Obviously, it's my hope that we will not have the regulators jumping ahead trying to rewrite the laws that we in the Congress are endeavoring to do at this very moment. But to the extent that any of you have any plans along those lines, I think you ought to tell us about them today so that they are on the record and we are all playing straight with all the cards on the table and face up.

So I'd be interested in anything that may be under way in that area.

Third, with respect to Third World debts or debts from Third World countries and companies, I know that a lot of the banks in the United States that have extended credit to Third World borrowers have found now those loans are not being repaid and cannot be repaid and I know some of the write-downs have been taken. Some have been taken almost completely. I gather that the regional banks with less exposure were in a position to do a better job of setting aside reserves against those presumed losses, whereas I understand that money center banks or at least some have had such large exposures that they have not been able to sufficiently reserve against those because if they were to do so it might exhaust their posted capital. I don't know whether that's accurate or not, but that's reported to be so.

So I'd like to get a sense as to that problem, the degree to which it may be more serious than has been recognized simply because we haven't put the bright light on it. I'd like to know the extent to which there are still substantial unreserved liabilities out there for Third World loans for some of the major banks in the country.

Mr. Chairman, those are the issues that I want to have our witnesses address today.

The CHAIRMAN. Thank you, Senator Riegle.

Before we begin, I have statements from Senators Dixon, Sasser, and Shelby to be inserted in the record.

STATEMENT OF SENATOR ALAN DIXON

Mr. Chairman, I am pleased to be here this morning as the Banking Committee reviews the condition of our Nation's banking industry. We have a distinguished group of witnesses before us this morning, and I look forward to their testimony. At the outset, I would like to make two brief comments.

First, thrift industry problems have received a lot of media attention recently, but there are continued banking industry problems that need our attention. The FDIC closed 184 banks last year, and has closed 59 already this year. These are extraordinarily high failure rates by historical levels.

Fortunately, the bank problems are manageable so far and do not present a threat to the overall banking system. The FDIC insurance fund has been able to handle the rising level of demand so far, although it is worth keeping in mind that FDIC payouts will exceed total fund income this year.

Second, we also need to explore how we can better equalize the treatment of large and small banks. Our largest banks noninsured deposits are protected more fully than the noninsured deposits of their smaller counterparts. We need to find a solution that does not adversely impact the international competitiveness of our largest banks—foreign competition has never been more fierce. At the same time, however, it is important to try to find a way to provide more equitable treatment so that smaller domestic banks are not competitively disadvantaged.

STATEMENT OF SENATOR JIM SASSER

Mr. Chairman, thank you for calling this very timely hearing on the condition of the banking industry. On the face of it, our banks appear to be in fairly good shape, but there are undercurrents that need to be carefully watched.

The Third World debt situation is not going away. I think the major banks are beginning to deal with the problem more realistically, and that this will help in the long run, but they have a way to go.

There are still enormous problems in the energy sector, although it appears that banks in the agricultural sector have turned the corner.

Last, I am troubled, Mr. Chairman, by the huge increase in leveraged buyout financing that banks are engaging in. I fear that this could be another major problem for banks in the future. I hope the regulators are monitoring it carefully. Thank you, Mr. Chairman.

STATEMENT OF SENATOR RICHARD SHELBY

Mr. Chairman, I commend you for scheduling this hearing today and for arranging to have such a distinguished panel of witnesses.

I am pleased to have this opportunity to get an overview from the experts on the condition of the banking industry. We hear statistics cited rather freely, often stating that X number of banks have failed, that the ratio of nonperforming assets is the highest since the war, and so forth.

Gentlemen, I have looked over your testimony. You have put the statistics in perspective for us. You identify the trend that surrounds the statistic. This is both reassuring, and unsettling. You are generally optimistic, you highlight the positive side of the trend, yet you are cognizant of the discrepancy between the strength of the economy and the condition of the banking industry.

Mr. Heller, in your testimony, you state that both nonperforming asset ratios and charge off ratios are high, which is troublesome when one considers that it is the sixth year of economic expansion. In the past, bank asset quality has shown improvement at an earlier point. You conclude that point with the observation that "any unforeseen shock or economic reversal could have serious negative implications for the loan portfolios of some banking organizations." That is what I term "unsettling." I hope you will elaborate on this later in the hearing.

Chairman Siedman, you testify that the Federal Deposit Insurance Corporation remains strong and stable. In light of last week's hearing on the condition of the thrift industry, that certainly is reassuring. The FDIC seems to have done a very good job of conserving cash during this difficult period for our banks.

Altogether, your testimony was enlightening. I look forward to your comments this morning.

Thank you.

The Chairman. We are honored to have these three distinguished regulators before us today. I'm going to ask you gentlemen to confine your oral remarks if you would to ten minutes. Your statement will be printed in full in the record. Go right ahead, Comptroller Clarke.

STATEMENT OF ROBERT L. CLARKE, COMPTROLLER OF THE CURRENCY

Mr. Clarke. Thank you, Mr. Chairman and members of the committee. As you indicated, I am here today at your invitation to discuss the condition of the national banking system. I have submitted for your consideration and for the record an extensive and detailed written statement, a heavy document in terms both of substance and of weight.

Rather than trying to summarize that statement this morning, I would want to put the condition of the national banking system in perspective by discussing three related points. One, aggregate statistics for the system, if taken alone, don't paint a useful picture of the system's performance last year. The aggregate statistics must be fine-tuned before an accurate assessment of the system's performance and condition can be made. Two, when a realistic assessment is made, two major areas of concern emerge. We are addressing those areas of concern. Three, while these two areas of concern demand our continuing attention, they should not overshadow the fact that the national banking system remains fundamentally sound. It has been put to some rather severe tests and has proved itself deserving of the confidence of the American public.

To return to the first point, why do aggregate statistics, if taken alone, cloud the picture of national bank performance last year? Because they oversimplify a complex situation. The performance of banks reflects the fortunes of their customers. The customers a bank serves are primarily determined by the markets it chooses to enter, or is able to enter, and the location where it does business. Thus, we can expect bank performance to differ as the performance of business sectors and regional economies differs.

Given the differing fortunes of bank customers, when we look beneath the aggregates, we can class national banks into four groups according to their operating results and the factors that contributed to those results last year: the large multinational banks with assets of more than $10 billion each, the regional banks with assets of $1 billion to $10 billion each, the banks in our Southwestern District, which encompasses the States of Texas, Oklahoma, Louisiana, Arkansas, and New Mexico, and the rest of the approximately 4,000 national banks with assets of less than $1 billion each.

OPERATING RESULTS VARY WIDELY

Operating results for each of these four components of the system varied widely. Starting with the last group first, the profitability and asset quality of these national banks increased last year. Most measures of their asset quality improved, and their capital ratios increased. Banks located along the eastern seaboard continued to benefit from the strong economic growth in the Northeast and Southeast. As in 1986, last year they outperformed banks in other regions. In the Midwest, profitability rose as many banks shared in the recovery of the agricultural sector.

The regional banks, those with assets of between $1 billion and $10 billion, also remained profitable, although their net income as a group declined by 25 percent. That decline reflects aggressive increases in loan loss provisions made by several larger regionals with loans to certain less developed countries [LDC's]. The important point to remember about the regionals is that their LDC exposure was less than that of the multinationals to begin with.

Turning to the multinationals, we find that their operating results dominated the performance aggregates of the national banking system in 1988. Industry earnings were depressed by sizable provisions for possible loan losses made by the multinationals in recognition of the uncertainty surrounding the repayment of loans by economically troubled, less developed countries. The 29 national banks with assets greater than $10 billion made provisions for possible loan losses of $16 billion in 1987, up from $6 billion in 1986. As a group, those banks lost nearly $5 billion in 1987 compared to profits of nearly $4 billion in 1986. Although those 29 banks make up fewer than one percent of all national banks, they hold more than 45 percent of national bank assets. As a result, their losses had a profound effect on the aggregate earnings of national banks. National banks in 1987 earned approximately $329 million, down from nearly $9.5 billion in 1986. Ninety percent of that decline in net income resulted from the fall in earnings of the 29 largest national banks.

The LDC problem is large by any standard. To address that problem, the OCC continues to support the program first outlined in 1985 by Treasury Secretary Baker, which involves a combined effort by multilateral financial institutions, commercial banks, and debtor governments to alleviate burdens associated with that debt.

The Baker Initiative aims at getting the debtor countries in shape so that they can service their debt with regularity and dependability in accordance with its terms, just as the industrialized countries service their debt. It is a long-term solution to a long-term problem, and it requires patience. Focusing on immediate debt repayment, as many creditors do, will only delay the resolution of the problem.

The OCC supports continued implementation and expansion of the Baker Initiative. We will continue to work with national banks as they devise restructuring solutions to reduce the outstanding principal owed to them by LDC debtors.

Finally, Mr. Chairman, we turn to banks in our Southwestern District, a section of the country where bank earnings were depressed from a distressed local economy in 1987. Sixty-one national banks failed in 1987, up from 48 in 1986. Two Southwestern States, Texas and Oklahoma, accounted for about two of every three national bank failures last year. Of all of our six supervisory districts, only the Southwestern District experienced an increase in the number of problem banks last year. As of last March, more than half of all problem banks were located in the Southwest, where an overabundance of commercial real estate has impaired the performance of national bank real estate loan portfolios.

My written statement extensively discusses the banking problems of the Southwest, their origin and their severity. In the interest of time, I won't detail them this morning, but I must stress that in Texas the condition of lenders depends on the prospects for real estate markets and the overall performance of the State economy. The glut of office space and the intense competition for tenants could keep downward pressure on lease rates for some years, so that a quick turnaround in the performance of bank real estate loan portfolios is not likely.

But recent data for the State's economy do indicate that the worst may be over. Many economic indicators for Texas leveled out in 1987 and advanced, although marginally, in the second half of the year. It will take time for changes in the economic environment to be manifested in the performance of banks. Ongoing improvement in Texas, coupled with continued strength in the U.S. economy, will aid that turnaround. In the interim, those problem banks with sound plans whose vital signs indicate some hope of recovery receive and will continue to receive regulatory assistance: capital forbearance, 13(c) open bank assistance, and so on.

Mr. Chairman, as I have indicated, the true condition of the national banking system can best be seen by looking beyond the aggregate measures of performance last year. There were problems. There continue to be problems. But those problems are under control.

Furthermore, as I reported, in 1987, profitability for the majority of national banks stabilized after years of steady erosion. Most measures of asset quality improved and capital ratios increased. In sum, the national banking system remains sound.

Mr. Chairman, in concluding my remarks this morning, I want to turn from the past to the future and to offer this personal assessment. As I've stated earlier, bank performance reflects the fortunes of bank customers, and bank customers are determined in large part by the markets which banks are able to serve. If national banks had had greater flexibility in defining their service and geographic markets in the past, the problems we have seen in some segments of the national banking system would have been mitigated, perhaps substantially.

Your efforts, Mr. Chairman, and those of the other members of this committee, led to Senate passage earlier this year of legislation that would move banks in the direction of greater competitive flexibility. Without similar action by the House of Representatives, there exists a great potential for fundamental erosion in the condition of the banking system across the board. That is a result that we must avoid.

Thank you very much.

[The complete prepared statement of Mr. Clarke follows:]

For release, May 25, 1988, 10:00 a.m.

STATEMENT OF
ROBERT L. CLARKE
COMPTROLLER OF THE CURRENCY
before the
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
May 25, 1988

INTRODUCTION

Mr. Chairman and members of the Committee, I am here today at your invitation to discuss the current condition of the national banking system. I am pleased to have the opportunity to do that.

Overall, the national banking system remains sound. Last year, many banks achieved significant improvements in profitability and asset quality, especially in the Midwest, where banks shared in the recovery of the agricultural economy. National banks in the Northeast and Southeast outperformed banks in other regions in 1987, benefitting from continued economic growth along the eastern seaboard.

Because the performance of banks reflects the fortunes of their borrowers, there are areas of concern. Certain banks, particularly some very large ones, experienced major losses last year because they made loan-loss provisions with respect to their loans to developing countries. Bank earnings were also depressed in sections of the country with distressed local economies, such as the Southwest, where an oversupply of real estate has impaired the performance of national bank real estate loan portfolios.

In my testimony today, I will begin by reviewing data regarding the current financial condition of national banks. I will examine their earnings, profitability, sources of revenue, asset quality, and capital. I will then address three supervisory matters that are of particular importance: our proposal to revise the guidelines for assessing capital adequacy, initiatives regarding loans to troubled, less-developed countries (LDCs), and the way we handle failing banks, and conclude by responding to several specific questions raised in your letter of invitation.

THE FINANCIAL CONDITION OF NATIONAL BANKS

The majority of national banks experienced a slight improvement in performance last year. Their profitability stabilized after years of steady erosion; most measures of asset quality improved; and capital ratios increased. Some national banks, however, fared poorly in 1987. Many in the Southwest and the large multinational banks incurred substantial losses. Overall, more than one national bank in five was unprofitable.

Earnings

Last year, national banks earned approximately $329 million, down from nearly $9.5 billion in 1986. Industry earnings were depressed by sizable provisions for loan losses made by large national banks, particularly with respect to the indebtedness of several LDCs. The 29 national banks with assets greater than $10 billion made provisions for loan losses of $16 billion in 1987--up from $6 billion in 1986. As a group, those banks lost nearly $5 billion in 1987, compared to profits of nearly $4 billion in 1986. Smaller national banks earned nearly $5.1 billion in 1987, compared to $5.7 billion in 1986.

Although those 29 banks make up fewer than one percent of all national banks, they hold over 45 percent of national bank assets. Therefore, their losses last year had a profound effect on the aggregate earnings of national banks. Earnings at those 29 national banks fell $8.5 billion between 1986 and 1987, accounting for more than 90 percent of the decline in the net income of national banks as a group. (See Table 1.)

TABLE 1

NET INCOME
(millions of dollars)
(National Banks by Asset Size)

Year	Under $300M	$300M-$1B	$1B-$10B	Over $10B	All Banks
1978	$1,851.1	$ 715.7	$1,661.0	$ 1,929.3	$6,157.2
1979	2,079.6	777.7	2,050.7	2,333.0	7,241.0
1980	2,190.3	859.2	2,082.9	2,527.4	7,659.8
1981	2,224.7	895.1	2,230.2	2,831.8	8,181.8
1982	2,208.5	805.0	2,339.4	2,841.0	8,194.0
1983	2,170.6	893.8	2,533.2	2,433.2	8,030.8
1984	2,015.7	1,061.2	3,811.7	1,383.1	8,271.7
1985	1,783.6	925.4	4,428.3	2,672.0	9,809.3
1986	1,312.4	824.1	3,603.1	3,728.1	9,467.8
1987	1,506.3	828.1	2,730.4	-4,735.7	329.1

Source: Call Reports

Return on Assets

With earnings of $329 million on assets of $1.8 trillion, the average return on assets (ROA) for the national banking system was a mere 0.02 percent in 1987, its lowest level in more than 50 years. Fortunately, that is not the whole picture. The aggregate results for 1987 were greatly influenced by the losses incurred by the largest banks and are not representative of the majority of smaller institutions. For the vast majority of national banks, earnings stabilized in 1987, following five years of significant decline. Half of all national banks earned at least 0.79 percent on their assets. This median ROA was well below its most recent peak of 1.11 percent in 1980, but was two basis points above its 1986 level. (See Table 2.)

TABLE 2

RETURN ON ASSETS
(All National Banks)

Year	Median	Mean
1978	1.01%	0.73%
1979	1.09	0.77
1980	1.11	0.73
1981	1.08	0.71
1982	1.04	0.66
1983	0.96	0.60
1984	0.92	0.57
1985	0.88	0.63
1986	0.77	0.57
1987	0.79	0.02

Source: Call Reports

Although declining profitability has been a persistent phenomenon during the 1980s, an equally important trend has been an increasing divergence in profitability among national banks. The ROA of banks below the median level has fallen much more sharply than the ROA of banks above the median level. As a result, the disparity between the profitability of the banks with the strongest returns and those with the weakest has widened substantially. In 1987, for the first time in six years, the disparity in profitability narrowed, but it still was substantially greater than it was a decade ago. (See Table 3.)

TABLE 3

DISTRIBUTION OF RETURN ON ASSETS
(All National Banks)

Year	5th Percentile	Median	95th Percentile
1978	0.18%	1.01%	1.70%
1979	0.28	1.09	1.87
1980	0.11	1.11	2.02
1981	-0.05	1.08	2.20
1982	-0.91	1.04	2.10
1983	-1.30	0.96	1.96
1984	-2.01	0.92	1.82
1985	-2.87	0.88	1.82
1986	-3.31	0.77	1.75
1987	-2.96	0.79	1.69

Source: Call Reports

This trend is consistent with several other observations. More banks are unprofitable, and the number of problem national banks has increased as has the number of bank failures. It also points out that, while banking as a whole is less profitable than it was earlier in this decade, the fall in profitability has been most pronounced among the poorest performers.

Some of this divergence in bank profitability can be attributed to regional economic differences. (See Table 4.) The most serious earnings problems for the past two years have been in the OCC's Southwestern District, which comprises Texas, Oklahoma, Louisiana, Arkansas, and New Mexico. Earlier in this decade, national banks in the Southwest substantially outperformed national banks in the rest of the country. In Texas, median ROA began to decline after 1981, as oil prices weakened and the pace of economic growth slowed, but it still exceeded the median ROA of national banks in other parts of the country. After 1983, the median ROA for national banks in Texas fell sharply below the median for all other national banks. In 1987, 47 percent of national banks in Texas lost money, and the median ROA was only about 0.06 percent, less than one-tenth the median for all national banks.

TABLE 4

MEDIAN ROA BY DISTRICT
(All National Banks)

District	1986	1987
Northeastern	1.11	1.08
Southeastern	1.08	1.03
Central	0.96	0.94
Midwestern	0.71	0.81
Southwestern	0.28	0.28
Western	0.39	0.51
All banks	0.77	0.79

Source: Call Reports

Weak regional economies are always a source of concern, but history suggests bank earnings typically improve as local economies rebound. That appears to be the case in the Midwest where profitability increased substantially last year; the median ROA in the Midwestern District rose from 0.71 percent to 0.81 percent.

Sources of Revenue

Interest revenue continues to be the largest source of revenue for national banks. Net interest revenue, defined as interest income less interest expense, was $58.9 billion in 1987, up from $55.8 billion in 1986. (See Table 5.)

TABLE 5

NET INTEREST REVENUE AND NONINTEREST REVENUE
(millions of dollars)
(All National Banks)

Year	Net Interest Revenue	Noninterest Revenue
1978	$25,615.4	$ 5,928.1
1979	28,769.0	6,983.0
1980	31,344.4	9,025.1
1981	34,199.8	11,029.5
1982	39,081.3	12,707.8
1983	42,063.6	14,611.9
1984	47,407.4	17,197.1
1985	53,596.7	20,658.1
1986	55,828.1	24,917.4
1987	58,928.7	26,458.5

Source: Call Reports

Banks have supplemented their interest revenue through securities trading and by offering services that generate fee income. In 1987, noninterest revenue (which includes income from fiduciary activities, fees for a variety of services, income from trading account activities, and gains and losses from securities and foreign exchange transactions) amounted to $26.5 billion, compared to $24.9 billion in 1986.

Two trends are evident in the data. First, the percentage of banking revenue coming from noninterest sources is increasing. Second, noninterest revenue represents a larger contribution to banking income at larger banks than at smaller banks. (See Table 6.) The growth in noninterest revenue is a healthy development, indicating product diversification and decreased dependence on a single source of income.

TABLE 6

NONINTEREST REVENUE AS A PERCENT OF PRINCIPAL REVENUE*
(All National Banks)

Year	Under $300M	$300M-$1B	$1B-$10B	Over $10B	All Banks
1978	12.60%	17.64%	21.57%	21.58%	18.79%
1979	13.18	18.16	22.34	22.13	19.53
1980	13.70	18.79	24.87	27.05	22.36
1981	14.38	19.61	26.73	29.83	24.39
1982	14.38	20.36	27.07	29.26	24.54
1983	15.34	21.42	29.00	29.77	25.78
1984	16.44	23.33	29.26	30.18	26.62
1985	17.78	24.04	29.75	31.55	27.82
1986	20.31	25.53	31.21	35.59	30.86
1987	18.87	24.61	28.76	37.77	30.99

*Principal Revenue = Noninterest Revenue + Net Interest Revenue
Source: Call Reports

Asset Quality

Despite a protracted period of economic growth, national banks have been beset by deteriorating credit quality for the past five years. (See Table 7.) Earlier in this decade, banks serving agricultural communities suffered substantial losses. Banks with loans to the oil and gas industry experienced similar problems, following the decline in worldwide oil prices and the contraction of the domestic energy industry. In 1987, conditions in both the agricultural and energy sectors had begun to stabilize, and credit quality at most national banks improved.

TABLE 7

NET LOAN LOSSES AS A PERCENT OF TOTAL LOANS
(All National Banks)

Year	Median	Mean
1978	0.17%	0.31%
1979	0.19	0.29
1980	0.25	0.38
1981	0.26	0.35
1982	0.36	0.59
1983	0.35	0.71
1984	0.38	0.86
1985	0.57	0.89
1986	0.74	1.01
1987	0.56	0.99

Source: Call Reports

There were some exceptions to that most recent development. The two most prominent were large banks with exposure to developing countries and banks in the Southwest, especially those that had engaged actively in commercial real estate lending earlier in this decade.

Troubled LDC loans. At national banks with more than $10 billion in assets, nonperforming assets as a percent of all assets increased by 50 percent last year. They rose from 2.40 percent in 1986 to 3.59 percent in 1987, with the increase largely attributable to the banks' LDC loans.

Foreign claims of all U.S. banks peaked at $359 billion in December 1983. They increased rapidly for several years prior to the onset of the debt crisis in the fall of 1982 and grew more slowly thereafter. From the peak, total foreign lending declined steadily to $291 billion at the end of 1987. As a percent of capital, total foreign exposure fell from 499 percent in December 1982, to 225 percent of capital in December 1987. That is the result of a $61 billion decrease in total lending and a $58 billion increase in capital. Those developments are illustrated in three charts that are appended to this statement.

The problems large national banks are having with some of their LDC loans have been a long time in the making. Beginning about 1980, the worldwide recession, higher interest rates, and lower agricultural and raw materials prices impaired the ability of Third-World debtors to meet their obligations. Eventually, banks rescheduled the debt and made interest rate concessions, but the

problems of some of the countries represented in the LDC loan portfolios of national banks continued.

Exposures of national banks to Brazil, Mexico, and Argentina are of special concern because of their size. In 1987, Brazil announced the suspension of interest payments on intermediate- and long-term, public- and private-sector foreign loan obligations to banks. Nonperforming loans rose sharply, and many large banks increased their provision for loan losses. Brazil's suspension of interest payments hampered its ability to raise new funds. At the end of 1987, a preliminary agreement between Brazil and its principal lenders was reached to provide for payment of interest for the months of January and February 1988. Negotiations toward reaching an agreement whereby all principal and interest will be brought current through mid-1988 are currently in a final stage.

Since 1986, economic conditions in Mexico have improved. A restored trade surplus has resulted in an increase in international reserves to $14 billion. Mexico has also engaged, with some of its creditor banks, in a debt-reduction program.

Argentina has relied in the last two years on loans from the International Monetary Fund (IMF) and the U.S. government, as well as private creditors who are willing to reschedule. However, Argentina's economy remains weak, but like Brazil, Argentina instituted in late 1987 government-sanctioned actions that enable foreign lenders to convert debt paper into equity investments.

Southwestern banks. For national banks in the Southwestern District, current problems also stem from lending decisions made some time in the past. As the outlook for the oil and gas industry began to dim in 1982-83, undermining the quality of oil and gas loans, many banks shifted their lending emphasis. Booming demand to finance construction and land development in Texas led local lenders, including commercial banks, to expand their real estate loan portfolios.

In retrospect, it is clear that the level of construction in Texas during that period was excessive, given the slowdown that was already underway in oil and gas activity; the level of construction depended on a pace of Texas economic activity that could not be sustained. Ultimately, after the collapse of oil prices in 1986, construction activity in Texas did contract sharply, but by then it was too late to forestall damage to the financial institutions that had financed new development earlier in the 1980s.

By last year, banks and other financial institutions in Texas were beset by mounting problems in their real estate loan portfolios. Nonaccrual real estate loans totalled $3.8 billion, up 400 percent from 1985. They accounted for 56 percent of total nonaccrual loans at Texas banks in 1987, twice the level of just two years earlier. (See Table 8.)

TABLE 8

NONACCRUAL REAL ESTATE LOANS
(All National Banks in Texas)

Year	Real Estate Nonaccrual Loans (millions of dollars)	Real Estate Nonaccrual Loans To Total Nonaccrual Loans	
		Median	Mean
1985	$ 766	28.1%	14.7%
1986	1,564	38.0	35.7
1987	3,842	56.0	43.7

Source: Call Reports

In Texas, the condition of lenders depends on the prospects for real estate markets and the overall performance of the State economy. The glut of office space and the intense competition for tenants could maintain downward pressure on lease rates for some years. Thus, a quick turnaround in the performance of bank real estate loan portfolios is not likely. Some recent data for the State economy do indicate that the worst may be over; many economic indicators for Texas leveled out in 1987 and advanced, albeit marginally, in the second half of the year. It will take time for changes in the economic environment to be manifested in the performance of banks, but ongoing improvement in Texas, coupled with continued strength in U.S. economy, will aid the turnaround.

Capital

Determining an adequate amount of capital for each national bank is not a simple matter. Judgments about adequacy are made by examiners in light of risks that each bank faces. Experience has taught us that relating capital to assets is a good place to start. Our current minimum standard for each bank--set forth in 1985 in our capital regulation--12 CFR Part 3--is that primary capital, principally stockholders' equity and reserves for loan losses, should be no less than 5.5 percent of total assets. I would emphasize that the standard is a minimum. We can, and do, direct banks to hold capital in excess of the minimum when circumstances warrant. As I will discuss later, we are in the process of revising that regulation in order to move toward a risk-based approach to judging capital adequacy.

Under our current standard, at the end of 1987, 96 percent of all national banks had primary capital ratios at or above the regulatory minimum; 87 percent had primary capital ratios above 6.5 percent. However, it is not possible to state categorically, relating only Call Report data to our minimum standards, how many national banks have adequate capital.

Examiner judgments of capital adequacy are summarized in a rating system. The number 1 is assigned to well-capitalized banks, a 5 to banks in need of substantial additions to capital. At the end of 1987, 81.3 percent of all national banks had a capital rating of 2 or better.

Capital ratios have been generally rising since 1979. On average, banks in all size classes increased their ratios of primary capital to assets, with the biggest improvement coming at the largest banks. (See Table 9.)

TABLE 9

PRIMARY CAPITAL AS A PERCENT OF ASSETS
(National Banks by Asset Size)

Year	Under $300M	$300M-$1B	$1B-$10B	Over $10B	All Banks
1978	8.05%	6.96%	6.10%	4.61	6.01%
1979	8.22	7.08	6.09	4.50	5.96
1980	8.40	7.29	6.08	4.54	5.98
1981	8.46	7.27	6.16	4.65	6.01
1982	8.48	7.31	6.19	4.80	6.10
1983	8.44	7.34	6.43	5.08	6.31
1984	8.54	7.42	6.48	6.11	6.78
1985	8.57	7.47	6.72	6.37	6.95
1986	8.43	7.42	6.73	6.73	7.06
1987	8.76	7.60	7.29	7.40	7.59

Source: Call Reports

Not all banks have been boosting their capital ratios in an identical manner. As bank size increases, the source of additions to primary capital generally shifts from additions to equity to additions to the loan-loss reserve. That shift has become more pronounced over time. At banks with assets of $300 million or less, equity was, on average, 90 percent of primary capital in 1987, about the same as in 1986 and down slightly from the 94 percent level of 1981. For national banks with assets over $10 billion, equity, on average, represented only 60 percent of primary capital. The loan-loss reserve represented 34 percent, twice that for 1986 and three times that for 1981, primarily a reflection of the sizeable provisions made in 1987 in response to those banks' LDC exposures.

Problem Banks and Bank Failures

The past and present problems in certain sectors of the economy continued to take their toll on the banking industry in 1987. Problem banks and bank failures remained at high levels, although the sharp increases of previous years appear to be abating.

Problem banks. After increasing steadily since 1980, problem national banks, those with composite CAMEL ratings of 4 or 5, declined in 1987. There were 315 problem national banks at the end of 1987, down from 326 a year earlier. As of March 31, 1988, the number had dropped to 309.

The decline in the level of problem national banks was most evident in the Midwestern District, where the number of problem national banks fell from 61 at the end of 1986 to 42 last year. Several factors contributed to that improvement, including rising government support payments to agriculture, higher livestock and farm-land prices, and lower production costs in agriculture.

Only in our Southwestern District did the number of problem banks increase during the past year. As of March 1988, more than half of all problem national banks were located in the Southwest.

Failed Banks. Sixty-one national banks failed in 1987, up from 48 in 1986. Two Southwestern states, Texas and Oklahoma, accounted for about two of every three national-bank failures last year.

Through May 19 of this year, 17 national banks had failed, compared to 31 national banks for the same time period last year. We do not foresee that the number of national-bank failures this year will be below last year's total. We do estimate that there will be a slight decline in the number of national-bank failures in 1989.

Causes of bank failure. There are various causes of bank failure. Weakness in the local economy obviously plays an important role. However, based on a study we recently conducted on failed banks, it is clear that capable managers are an integral factor in determining a bank's vulnerability to lean economic times. By the same token, weaknesses in the local economy expose poor managers who might have survived under more robust economic conditions.

In our study, we found that weak boards of directors and/or management contributed significantly to failure in 90 percent of 185 national banks that failed between 1979 and year-end 1987. Other factors that had a significant influence on failure included insider abuse (present in 36 percent of the failed national banks examined) and fraud (present in 12 percent). Depressed local economic conditions, while present in the majority of failed banks, were judged to be a significant cause of failure in only 35 percent of the banks, despite the disproportionately high failure rate in the Southwestern district.

SUPERVISORY RESPONSE

The OCC, along with other bank supervisors, is striving to address the major problems facing the banking industry. Three areas that are part of our continuing supervisory efforts include: implementing a better method of assessing capital adequacy; alleviating the burdens associated with LDC debt; and handling insolvent institutions.

Risked-Based Approach to Capital Adequacy

Existing capital standard. In order to ensure that bank capital requirements appropriately reflect the risks banks face, we are developing, in cooperation with other federal bank supervisors, a new approach to the measurement and regulation of capital adequacy. The current capital standard has several weaknesses, which the new approach is designed to address.

First, the existing capital standard fails to differentiate explicitly between high-risk and low-risk assets. For example, U.S. Treasury obligations and loans to unrated commercial borrowers require identical capital, despite the fact that the former poses the smallest amount of credit risk that can be found in the marketplace. Second, the current standard does not require capital against off-balance sheet activities, such as standby letters of credit and loan commitments, which can expose the bank to more risk than do activities on the balance sheet. Third, it has allowed some banks to rely too heavily on the loan-loss reserve at the expense of equity. Fourth, the existing capital standard applies only to U.S. banks, resulting in inequitable standards among many banks that compete side-by-side in international markets.

Our current proposal. The OCC has worked with other U.S. bank supervisors and bank supervisors from several foreign countries to develop a capital standard that addresses each of those weaknesses. All have agreed to rank bank assets and selected off-balance sheet commitments in terms of their credit risk. High credit-risk instruments would require more capital than lower risk instruments.

The agreement calls for a minimum total capital to risk-adjusted assets ratio of 8 percent. In meeting that requirement, banks would have to have Tier 1 capital, which is essentially stockholders' equity, equal to at least 4 percent of risk-adjusted assets. The balance of the required capital could be met with additional Tier 1 capital or Tier 2 capital, which under the current proposal consists of certain types of preferred stock, subordinated debentures, and limited amounts of loan-loss reserves.

Our proposal focuses primarily on credit risk. However, a banking organization's capital base must be able to absorb losses stemming from other kinds of risk, such as foreign-exchange risk, liquidity or funding risk, and interest-rate risk. Thus, supervisory judgments of a banking organization's capital adequacy will continue to go far beyond simply calculating a capital ratio. Nevertheless, the risk-based standard provides bankers, investors, and bank supervisors with a useful benchmark or starting point to use in the analysis of capital adequacy.

I am aware of concerns that implementation of the risk-based capital proposal will place U.S. banks at a competitive disadvantage and will force them to raise capital funds by issuing equity securities. In assessing those concerns we must keep in mind that our proposal would give banks until 1992 to achieve compliance. Moreover, we estimate that the number of banks that would have to raise capital is small. Although we do not have precise data on the current risk-based capital ratios of banks, our data suggest that only 155 national banks, including the multinational banks, have Tier 1 capital ratios below 4 percent, and 478 national banks have total risk-based capital below 8 percent. It is also important to keep in mind that risk-based guidelines offer banks the option of adjusting their asset portfolios towards less risky assets. We also believe that the vast majority of nationally chartered community and regional banks would now easily meet the risk-based requirements.

Finally, a significant feature of the proposal is that it promotes comparability of capital standards among countries. The current proposal is the result of an agreement among twelve countries. Its adoption will help move us toward international competitive equity.

LDC Debt

Approximately $300 billion of LDC debt is held by lenders in the world's industrialized countries. The 20 largest U.S. banks hold about $70 billion of that debt.

The OCC continues to support implementation of the approach originally put forth by Treasury Secretary Baker, which involves a concerted effort by multilateral financial institutions, commercial banks, and debtor governments to alleviate burdens associated with that debt. The ultimate objective remains to assist national banks in facilitating solutions and transactions that will result in troubled LDCs being able to service their remaining obligations according to the terms of their debt agreements.

We believe that more could be done by U.S. banks and debtor governments to implement the Baker Initiative and the private-sector menu items enumerated by Secretary Baker earlier this year in remarks to the Bretton Woods Committee. Banks could take several steps to reduce the payment burdens of debtor countries and at the same time receive a more certain means of repayment. These include: exchanging debt for direct equity investments or new notes or bonds convertible into local equity; converting term debt to general balance-of-payment loans; making trade and project loans to support private-sector production, in concert with IMF and World Bank structural readjustment programs; and agreeing to accept exit bonds that streamline new financing packages.

At the same time, debtor countries need to adopt more willingly macroeconomic and structural policies designed to promote economic growth that will reduce the burden of overall debt-repayment obligations.

There are bright spots, such as Chile, where the Baker Initiative is working well, because of the cooperative action of the debtor government, its private industries, and foreign creditors. To date, creditors of Chile have converted nearly 20 percent of that country's outstanding debt to productive equity investments. A similar open, clearly-defined, and positive debt/equity swap program should be encouraged in Argentina, Brazil, Mexico, and other developing countries to expand investment in local enterprises.

The OCC has used, and will continue to use, our regulatory authority to support implementation of the Baker Initiative and the menu items. In particular, we issued an interpretative letter in late 1987 approving the International Bank of Miami's exchange of $2 million in Mexican government debt for a 60 percent interest in a holding company that will own and operate private-sector real estate. In reviewing this transaction, the OCC recognized the bank's authority to take property in satisfaction of debts previously contracted (DPC). Other national banks have requested interpretations from our agency involving similar transactions in Mexico and other countries, and we anticipate that use of DPC authority by national banks will increase, especially if debtor governments amend their investment codes to permit investment by creditors in local industries.

In January 1988, the OCC also supported the debt-for-Mexican-government-bond swap program by issuing an opinion letter prospectively authorizing national banks to carry the new Mexican bonds as loans, within their legal lending limits, or, under certain conditions, as investment securities.

In the future, the OCC intends to review transactions proposed by national banks relying on any of the legal procedures described above, and also to assist national banks in structuring solutions to reduce the outstanding principal owed to them by LDC debtors.

Insolvent Institutions

Basic principles. As the supervisor of the national banking system, the OCC plays an important role in minimizing the negative impact that troubled or insolvent national banks can have on the safety and soundness of the banking system and its deposit insurance fund. The success of our supervisory efforts cannot be judged, however, simply by looking at the rate of bank failures.

We are, however, very concerned about bank failures, particularly those that can be attributed to fraud and negligence. In our testimony of last November before the Subcommittee on Commerce, Consumer, and Monetary Affairs of the House Committee on Government Operations, we stated that no level of bank fraud or insider abuse is acceptable and that those who commit such acts must be punished. Despite our best efforts, fraud contributes to some bank failures, as our study of bank failures indicated.

To strengthen our ability to handle this problem, the federal bank and thrift supervisory agencies developed and recently submitted to Congress a joint proposal to amend the law to enhance our existing enforcement authority and better equip us to supervise the nation's depository institutions. One such amendment would clarify that the cease-and-desist authority provided under 12 U.S.C. 1818(b) includes the right to order directors of a national bank to reimburse their bank for losses resulting from their violations of law.

In dealing with insolvent or nearly insolvent banks, the OCC assists all concerned parties to work out a solution that is least costly to the FDIC, as required by the Federal Deposit Insurance Act. It is our policy not to insulate bank ownership or management from the consequences of their actions. Generally, uninsured depositors and other creditors are not given the same protection as insured depositors. They share with the FDIC in the proceeds of liquidated assets. On some occasions in recent years, all creditors have been protected. In those cases, it had been determined that to have done otherwise could have exposed many other banks to fail, subjecting the FDIC fund to additional burdens.

Supervisory options. Bank supervisors have many options for dealing with insolvent institutions. These include deposit payoffs, where the bank is liquidated, and purchase and assumption agreements involving the sale of the failed bank, less some or all of its bad assets, to a sound banking organization. In addition, there is the tool of open-bank assistance, where, in order to prevent the closing of a failing or insolvent institution, the FDIC advances funds to the institution in the form of a loan, purchase of assets, or other transaction, usually accompanied by the infusion of private capital.

The technique of open-bank assistance, as currently practiced, is relatively new. It is available to both small and large banking organizations, when the FDIC determines it is less costly than a deposit pay-off. Additionally, the FDIC Board of Directors will only approve applications for open-bank assistance if certain conditions are met. Those conditions are intended to ensure that banks receiving assistance have a good chance of becoming strong competitors and that managers, directors, and stockholders are treated in substantially the same way that they would have been treated if the bank had actually closed.

Between the beginning of 1987 and April 20 of this year, the OCC worked with the FDIC in providing open-bank assistance to a number of national banks. These banks ranged in size from less than $10 million to over $1 billion. In one form or another, the FDIC spent slightly more than $2.1 billion in assisting those banking organizations.

Although the number of national-bank failures is likely to remain at a high level this year, we have most of the tools necessary for minimizing the difficulties that will create. Our problems would be less difficult if there were no legislated restrictions on branching and bank holding company acquisitions. We do not, however, favor suggestions made in other settings that would permit banks to carry assets at inflated values, or would extend or expand the capital forbearance program.

OTHER BANKING ISSUES

That completes my assessment of the major themes that describe the condition of national banks and our supervisory response. I now turn to a number of issues raised in your letter inviting me to appear before this Committee. They cover concerns about the chartering and performance of new banks, several banking-market issues, examination scheduling, and the adequacy of staff resources at the OCC.

New Banks

Chartering policy. Our current chartering policy was adopted formally in October, 1980, and is set forth in 12 CFR 5.20. Briefly stated, our decisions to grant charters are guided by the principle that, to the greatest possible extent, entry and exit decisions in banking are the province of the marketplace, not the government. Thus, we extend charters to those who have the financial, managerial, and other resources needed to operate a bank in a safe and sound manner and a demonstrated commitment to do so. We do not attempt to protect existing banks from the competition that a new bank may provide.

In evaluating charter applications, the Office assesses whether a proposed bank will have a reasonable prospect for success based on the experience, competency, and integrity of the organizers, the adequacy of the proposed capitalization, and the prospects for the business plan in the context of the economic and competitive conditions in the market to be served. When economic conditions deteriorate, applications filed typically decline, and the rate of denial usually rises.

The result of Office policy can be seen in Texas. As the Texas economy began to sour, the percentage of Texas applications denied increased steadily from a low of 2 percent in 1982 to a peak of 26 percent in 1985. In 1986, two out of a total of 14 applications acted upon were denied, and in 1987 two out of a total of three applications were turned down. Our denial rate for Texas charters reflects the difficulty that potential bank organizers face in developing operating plans that satisfactorily address a distressed economic environment.

Performance of new banks. Since 1981, the OCC has chartered 1,159 national banks. Eight-five percent of those banks are still operating. Sixty-one have failed, comprising 34.4 percent of all national bank failures since 1981. A higher failure rate for new banks than for established banks is in keeping with developments in other industries. For example, in 1986, according to data compiled by The Dun & Bradstreet Corporation, 61 percent of all business failures involved firms that had been in operation six years or less.

In recent years, the profitability of new national banks has declined. The median return on assets of new national banks (defined as those in operation for not more than three years) declined precipitously from a peak of 0.47 percent in 1981 to a low of -0.47 percent in 1987. Over the same period, the median ROA of mature national banks declined from 1.09 percent to 0.82 percent. As a result of diminished profitability and the amendment of anti-branching statutes in several states, the number of applications for new national banks declined each year from 1981 to 1986 before increasing slightly in 1987. One hundred and nine applications were received in 1987, down from 267 applications in 1981.

Asset Securitization

Asset securitization is a process whereby banks sell assets or borrow against them. It is simply another method for attracting funds to carry on traditional bank lending activities. It has enabled banks to free themselves from normal funding constraints and to lessen their vulnerability to changes in local economic conditions.

I am aware that some who follow banking developments wonder if banks will securitize their best assets, leaving them with only their poorest loans. That concern has not been validated by the transactions that have taken place. Rather, asset securitizations typically involve standardized loans that are selected because they have well-understood repayment characteristics, not because they are the bank's best loans. To date we have not observed any deleterious effects of asset securitization on the quality of bank portfolios.

Thus far, most securitization activity has been concentrated in the residential real estate mortgage area where the market for asset-backed securities is well-established. As currently practiced, it has significantly increased the liquidity of otherwise nonliquid bank assets and provided bank lenders with a steady stream of fee income. This has been accomplished with the assumption of very little additional risk and with an expansion of competitive banking services available to the public.

Judging from that experience, it is logical to assume that the wholesale extension of the securitization process to other consumer loans (some consumer credit card and automobile paper originated by banks have been securitized) and to commercial credits will yield similar benefits, with relatively low levels of risk for well-managed banks.

Globalization of Financial Markets

The financial services industry has witnessed a remarkable and rapid development of international markets. This has been made possible by major leaps in information technologies and increased competition among international commercial bankers, investment bankers, and securities exchanges. Also, some countries with major money centers have liberalized their regulatory structures to enhance their roles as financial centers.

But computers and deregulation here and abroad are not the cause of this global evolution in the financial markets; rather they are providing the means for the financial services industry to respond to demands of the market. Customers, such as U.S. corporations, require the ability to raise capital in a variety of countries or hedge interest- and currency-rate risks. Access to international markets allows them to satisfy those needs at the lowest possible cost. The U.S. economy benefits as capital costs of U.S. firms are reduced.

In order to compete in these markets, bankers will need to develop new and sometimes complicated products. Indeed, they have already found new ways to generate income. Some of the new instruments will involve parties from several countries and bear some of the characteristics of debt, securities, and futures contracts. These financial instruments will pose new challenges for bank management and regulators.

It is important that the U.S. responds in a way that allows our banks to compete on an equal footing with their international competitors, consistent with adequate protection of insured deposits. The evidence suggests we have been slow to give national banks the flexibility they need.

We must do several things. First, we must avoid the temptation to discourage banks unnecessarily from participation in global markets merely because we are afraid they may be exposed to new risks or because the arrangements are complex. We must allow bank managers to exercise their own judgment, and, as is inevitable, to suffer some losses. Our job is to make sure the bank has policies and procedures designed to protect insured deposits and to deal with losses when they occur. Second, when we impose certain regulatory requirements, we must work with our counterparts in our major trading partners to avoid placing U.S. banks at a competitive disadvantage. Finally, we must relax constraints on permissible bank activities to accommodate changing financial markets. Failure to do so will only mean that the markets for new financial services will develop outside our shores. The Senate has already taken an important step in preventing that development with the passage of S. 1886.

Support of Securities Markets

The events surrounding "Black Monday" have raised concerns about the effects of such a calamitous event on banks and their customers. OCC staff has investigated that issue in response to an inquiry from Congressman Barnard. We conducted interviews with senior bank officers from a cross-section of eight regional and multinational banks concerning their experiences during the October 1987 market crisis. The national banks that routinely provide credit to market participants continued to provide credit support to the securities industry during that time. In almost all instances, those banks extended credit to market participants when asked to do so and on their usual terms.

Double Leveraging

Double leveraging is the term given to the issuance of long-term debt by a parent bank holding company, with the proceeds being invested as equity capital in one or more subsidiary banks. There has always been concern that the holding company parent would place special demands upon the its subsidiary banks for dividends and other payments so that it could meet interest payments on the debt it issued. We rarely see such pressure placed on national banks that are members of holding companies. When we do, we exercise our authority to limit a bank's payment of dividends and otherwise restrict flows of capital from the bank to the parent, if that capital is needed in the bank.

Bank Examinations

Examination scheduling. Within the context of our limited resources, implementation of the OCC's 1988 supervisory plan is on schedule. Approximately one-third of the way into 1988, OCC has completed 1,440 or 36 percent of its planned on-site reviews for 1988 and has completed 1,403 or 33 percent of its regularly scheduled analyses for the year.

Supervision of national banks is an ongoing process, involving both on-site and off-site reviews. Examiners are assigned a portfolio of individual banks and for each they develop an annual supervisory strategy specifically tailored to that bank. It includes a list of our concerns and ways to address those concerns. Updates are performed as circumstances warrant. Generally, at least once a year, the OCC sends the bank a Report of Supervisory Activity. This report addresses supervisory actions or concerns and requests that the bank respond to the findings.

Adequacy of examination staff. As the members of this Committee recognize, OCC needs a workforce that is sufficient both in number and experience to deal effectively with the complexities of today's financial services industry. In the past, high turnover levels prevented us from maintaining optimal staffing levels. In

addition we instituted a hiring freeze in 1986 to stay within Gramm-Rudman-Hollings spending targets. Although we are now making progress toward appropriate staffing levels, it takes some time for a newly hired employee to gain the skills required to become fully productive. Our current need for greater numbers of seasoned examiners, therefore, is the legacy of past interruptions in our hiring and high turnover. Approximately 25 percent of OCC's commissioned examiner positions are vacant. Functions that would ideally be performed by commissioned National Bank Examiners are now performed by less-experienced Assistant and Associate National Bank Examiners. Although we have seen some reduction in overall turnover, I am concerned that our continued ability to meet our scheduled examination priorities with the professionalism and expertise they deserve is being compromised.

CONCLUSION

Despite all its well-publicized problems, the national banking system is fundamentally sound. It has been put to some rather severe tests and has proved itself deserving of the confidence of the American public.

The true condition of the national banking system can best be seen by looking beyond the typical aggregate measures of performance that were influenced by the results for a few dominant banks. As I have reported, for the majority of national banks, profitability stabilized after years of steady erosion; most measures of asset quality improved; and capital ratios increased.

However, we remain concerned about the problems faced by national banks. We have joined with bank supervisors here and abroad to fashion a risk-based approach to capital adequacy. Within the limits of the national banking laws, we are working with the large banks as they explore innovative financial arrangements that accommodate their needs and those of their troubled LDC customers. We are working with the FDIC to ensure that we deal with troubled institutions in the least-costly manner. In that regard we have assisted in several open-bank assistance transactions.

Banks must be sensitive to the excesses that led to current problems. Today, banks in the Southwest are having difficulties; several years ago, that was true of banks in the Northeast and Southeast that are doing relatively well. The business cycle is a fact of life, and only by maintaining prudent credit standards and building capital during good times can banks prepare for the inevitable downturns in their markets.

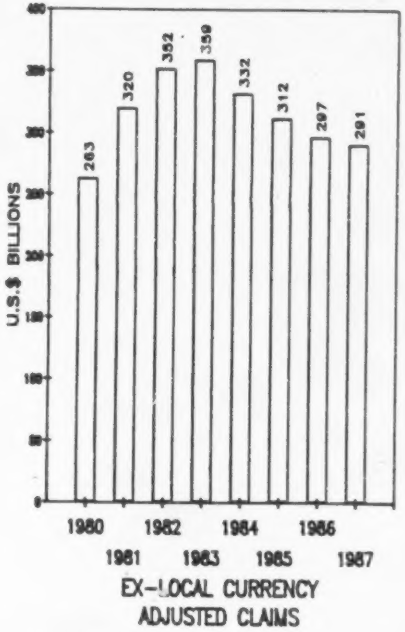
There are other problems facing our banking system. As I have stated in other appearances before this Committee, I am concerned about the constraints on the ability of national banks to respond to the increasing competition that they face in the market for financial services. There are many reasons for my concern: there are the impediments that prevent banks from providing services that would benefit consumers; there are the provisions of federal law, which permit securities firms and insurance companies to offer a wide range of banking services, but limit the securities and insurance services available from banks; and there is the long-run decline in the profitability of banking itself.

Your efforts, Mr. Chairman, led to Senate passage earlier this year of legislation that would remove some of the limitations on the ability of banking organizations to respond to that competition. Without similar action by the House of Representatives, there exists the potential for a fundamental erosion vitality of the U.S. banking industry--a result that must be avoided.

APPENDIX

Charts on Foreign Debt Exposure

FOREIGN CLAIMS OF U.S. BANKS ARE NOW BELOW 1981 LEVEL AFTER PEAKING IN 1983



SOURCE: FFIEC

The CHAIRMAN. Thank you very much, Comptroller Clarke. Chairman Seidman.

STATEMENT OF L. WILLIAM SEIDMAN, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. SEIDMAN. Thank you, Mr. Chairman and members of the committee, I'm pleased to present the views of the Federal Deposit Insurance Corporation on the condition of the banking industry and of our insurance fund.

Despite increased competition from all sectors of the financial community, severe economic problems in parts of our country, and an unprecedented pace of change in the industry, the banking system as a whole continues to be sound. And the same, fortunately, can be said for the FDIC fund.

Our response to the questions raised in your letter of invitation are contained in my written statement. I would like to devote my time today to six key issues that we deem most significant in assessing developments in the banking industry today.

SIX KEY ISSUES

The first is bank failures. Despite a record number of bank failures and assisted transactions in 1987, the financial condition of the FDIC fund remains strong and stable. At year end 1987, the insurance fund's net worth was $18.3 billion, a modest increase of roughly $50 million over the previous year, and we have just received our GAO audit report with a clean certificate to that effect.

Based on current estimates of losses and closings in 1988, including the loss of First Republic Bank of Dallas, TX, we may experience some decrease in the net worth of the fund in 1988. Such a decline in the FDIC insurance fund, if it occurs, would be the first in the history of the FDIC. Despite this, we believe the FDIC fund is sufficient to deal with any problems we can foresee in the banking system in 1988.

My second topic is the world position of U.S. banks. The world stock markets appear to have made some judgments about the future of global banking institutions. One study as of year end 1986 lists the 50 financial institutions with the largest capitalized market values. This includes not only banks but insurance companies, securities firms, and others. The number of shares times the price per share gives us what the market believes the companies are worth.

There were only eleven U.S. financial service companies on the list of 50 and only two were primarily banking organizations. The numbers have changed only slightly since the end of 1986. As you might expect, Japan had the most companies, with 27 on the list.

It seems clear that the stock markets do not believe that many U.S. banks will be among the future leading global financial institutions under current conditions.

Let me move then to LDC debt and debt reserves. As a result of the significant increase in bad debt reserves by most major U.S. banks in 1987, the banking system is in a much improved position in terms of its exposure to LDC debt. The money center banks have increased reserves to approximately 25 to 30 percent of their non-trade LDC exposure. The larger regional banks took additional reserves as chargeoffs and now have reserves covering approximately 15 percent of their nontrade LDC debt. And it appears that most of these banks intend to terminate this type of lending.

Based on the use of 25 percent of export income to service debt, we believe the levels of reserves taken as a whole appear reasonable for present conditions and we have some material to back that.

Let me move then to the Southwest banking problem. The main banking problems in the United States have been and continue to be concentrated in those sections of the country suffering from severe economic problems.

For example, from the beginning of 1986 until today, banks accounting for roughly 50 percent—I repeat—50 percent of the banking deposits in the States of Alaska, Oklahoma, and Texas have required or are expected to require financial support. This includes not only FDIC support but also private sector mergers of larger institutions.

Such widespread weakness in those States will continue to be a significant burden for the FDIC at least for the short run, although we agree with the statements of the Comptroller that there are some signs of improvement in the economy in that area.

My next subject is removal of the safety net from holding company creditors. Recent events, especially the First City and First Republic cases, have demonstrated the FDIC's resolve to promote stability within the banking sector without extending the Federal safety net beyond the bank to the parent holding company creditors. In contrast, in the case of Continental Illinois holding company, creditors were protected.

To aid us in fulfilling this objective, we have recently forwarded draft legislation to this committee that would allow the regulators to require the emergency consolidation of failing banks with other banks in a multibank holding company system. Disparity of treatment of banks and their parent holding companies has not been confined to supervisory authority. The investment community now demands an interest premium over bank CD's to provide funding to bank holding companies. We believe it is imperative that the safety net be restricted to banks if holding companies are to have additional financial powers.

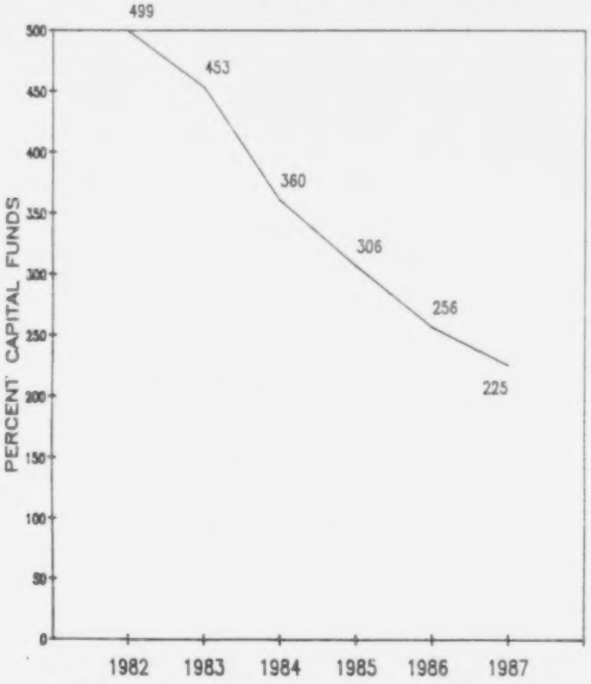
Let me move then to the thrift industry problems. The difficulties of the thrift industry and of their insurance fund, FSLIC, are having negative ramifications on the banking industry as well. The problems in that industry are creating higher cost of funds, forcing banks to compete in an unfair environment against insolvent institutions. This situation tends to have a destabilizing effect on the industry.

Therefore, the resolution of the FSLIC problem is important to the banking system and to the entire financial system. We believe it is appropriate at this time to undertake a complete review of deposit insurance and its role and operations in the current banking environment. Our study on this subject called "A Deposit Insurance System For the '90s" has been underway for several months and it will be completed before year end.

Although sound, the banking industry is experiencing a stressful period of evolution. There are problems and challenges that must be faced by banks, bankers, regulators and the Congress. These problems are not easily resolved, but we believe they can be managed. We look forward to cooperating with the Congress in whatever way possible to ensure the banking industry remains safe and sound, remains the backbone of the U.S. economic system, and is a vital competitor in world markets. Thank you.

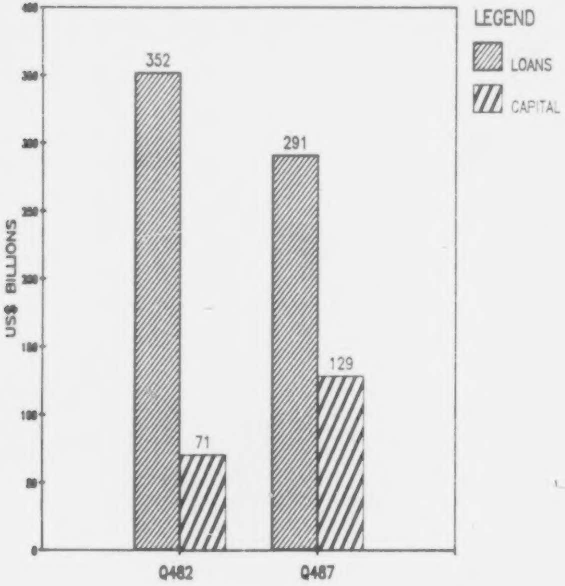
[The complete statement of Mr. Seidman follows:]

FOREIGN CLAIM EXPOSURE OF U.S. BANKS – AS PERCENT OF THEIR TOTAL CAPITAL FUNDS



SOURCE: FFIEC

EXPOSURE IS REDUCED BECAUSE CAPITAL IS UP $58 BILLION LOANS ARE DOWN $61 BILLION



SOURCE: FFIEC

LETTER TO THE EDITOR

Mutual Fund Rule Changes Would Not Usurp SEC Authority

To the Editor:

I am concerned that the story titled "Comptroller May Broaden Fund Powers," which appeared in your May 19 edition [page 1], may mislead your readers into thinking that this is a new idea to give banks new mutual fund powers beyond the reach of Securities and Exchange Commission regulation. In fact, changes in the rules governing common trust funds have been under consideration for the for the past six years. These changes would be entirely consistent with existing law.

In 1982, the Office of the Comptroller of the Currency published a notice in the *Federal Register* asking for comment on several parts of our trust fund regulation, including advertising of common trust funds. In January 1983, the *American Banker* reprinted a speech I gave on this same subject. In the speech, I noted that we were currently drafting regulations on commingled investment funds that would include, among other things, modification of the advertising prohibition and modification of the management fee provision.

The Comptroller's office suspended action on these regulatory changes pending the outcome of extensive litigation on commingled individual retirement accounts. However, in late 1986, after four favorable court rulings, the Comptroller's office again began drafting a proposed rule on this subject. This effort was repeatedly noted in the Comptroller's semiannual regulatory agenda, which was published in the *Federal Register*. I have also continued to mention in speeches that we were drafting this proposal.

Most importantly, I believe the statements made by the Investment Company Institute in this story misrepresent the situation. The Comptroller's draft proposal would not change existing legal requirements that common trust funds be offered for fiduciary purposes and not solely for investment purposes. We have repeatedly said, and the courts have agreed, that banks may advertise any service they may lawfully offer. The removal of advertising limitations for common trust funds would not allow banks to advertise services (such as garden-variety mutual funds) that they may not offer under current law.

In addition, the proposal would not usurp in any way the SEC's authority to regulate bank collective investment funds to the extent allowed under the federal securities laws, just as the SEC now regulates collective IRA funds offered by banks.

The proposed rule is still in draft form. Before it can be published for comment, it must be reviewed and approved by senior Comptroller officials and then submitted to the Treasury Department and the Office of Management and Budget for their approval.

Dean E. Miller
Deputy Comptroller
Office of the Comptroller
Of the Currency
Washington

TESTIMONY OF

L. WILLIAM SEIDMAN
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, D.C.

ON

THE FINANCIAL CONDITION OF FDIC-INSURED INSTITUTIONS

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

10:00 a.m.
May 25, 1988
Room SD-538, Dirksen Senate Office Building

Good morning, Mr. Chairman and members of the Committee. I am pleased to present the Federal Deposit Insurance Corporation's views on the condition of the banking industry and its insurance fund. At your request, the regulators already have submitted, through the Federal Reserve Board, a variety of statistics. My testimony today will provide an overview of the financial condition of FDIC-insured banks and respond to the specific questions raised in your letter.

First let me suggest a perspective for my remarks. The business media ordinarily focus on banking problems — as does, in fact, my own testimony today. That is only natural as most of our time is spent dealing with those problems. However, the real news is that, despite increased competition from all sectors of the financial community, severe economic problems in parts of our country, and an unprecedented pace of change in the industry, the banking system as a whole is sound and is getting sounder. Given a reasonable ability for the system to evolve and adapt through a prudent restructuring of the financial services industry, that assessment should continue to be true over the long run.

GENERAL ECONOMIC CONDITIONS

I would like to preface my discussion of the financial condition of the banking system with some general observations on the economy.

In last year's testimony we suggested that agricultural problems had bottomed out and that slow gradual improvement could be anticipated for 1987. That turned out to be the case and improvement in that sector is expected to continue in 1988. Despite this improvement, the problems of agriculture and agricultural banks are not over. The upturn is slow and banks' performance normally lag the economy both on the way up and on the way down. However, even though problems are still there, the trend is in the right direction.

We also indicated last year that the energy economy had apparently reached bottom, but the ripple effect had not yet run its course through the rest of the local economy. Therefore, banks could expect more problems. It is perhaps arguable whether or not the energy sector had indeed bottomed out. It does not appear any worse than last year, but certainly no one would describe it as in a robust recovery. There is no doubt that the ripple effect, particularly in the real estate markets, continues to cause serious problems for banks. Office vacancy rates in energy-centered areas are among the highest in the nation. A large volume of property is being withheld from the market, though not by the FDIC, to prevent oversupply. Hopefully, property value declines are nearing an end. Even in that event, the adverse effect on the economy and on banks in these areas will continue for some time.

Last year we also expressed some concern over the aggregate levels of debt outstanding, especially consumer debt, with much of it owed to commercial banks. While we are still concerned, the rate of increase in this debt has been reduced, thus decreasing the probability that it will become a major banking problem.

Another area of concern is interest rates, particularly the effect a rise in rates would have upon the thrift industry. Many of these institutions already

are having problems with asset quality. If interest rates increase, the resulting impact on thrift earnings may well exacerbate the financial difficulties of that industry. Fortunately, interest rate risk in the banking industry is not large at this time.

FINANCIAL CONDITION OF THE INDUSTRY

Capital — Aggregate primary capital of all insured commercial banks grew from $214 billion at year-end 1986 to $234 billion at year-end 1987, a 9.4 percent increase. However, nearly all the growth in primary capital occurred in the reserve for losses component which resulted from the loss provisions made by the large money center banks for troubled loans to developing countries. This new reserving provided adequate, if not comfortable, reserves against developing country loan risk. Smaller banks continue to have higher capital to asset ratios than larger banks. The Southwest Region, dominated by the energy industry and once comprised of banks with some of the strongest capital ratios, experienced sizable declines in capital during 1987, and now exhibits some of the weakest capital ratios.

The growth in capital outpaced the less than two percent growth in assets during 1987. The industry as a whole currently has an adequate level of capital. However, a continued growth in capital is necessary to maintain that position, especially if asset growth returns to higher levels.

Current minimum capital rules set substantially similar capital requirements for all banks, regardless of asset size or the identity of the bank's primary Federal supervisory authority. These capital-to-asset, or leverage, ratios continue to serve as useful tools in assessing capital adequacy, especially for banks that are not particularly active in off-balance sheet activity. However, the FDIC believes there is a need for a capital measure that is more explicitly and systematically sensitive to the risk profiles of individual banking organizations. While a risk-based system may require certain individual institutions to increase capital, these increases will help to further stabilize and strengthen the banking system.

The FDIC recently joined the OCC and Federal Reserve in issuing for comment a risk-based capital proposal based on an internationally agreed outline. This proposal is part of an ongoing effort by the bank regulatory authorities, both in the United States and in foreign countries, to encourage the establishment and convergence of international capital standards that would apply to all international banking organizations.

The FDIC proposal would apply to all State nonmember banks, regardless of size. However, we are considering ways to minimize the impact on smaller banks by exempting them from unnecessary and cumbersome reporting requirements. Our present estimate is that few smaller banks would be required to increase capital as a result of applying the proposed risk-based standards. At this time, the proposal would not replace or eliminate our existing capital maintenance regulations, which require minimum levels of primary capital and total capital as a percent of total assets. However, once the risk-based capital framework is fully implemented, the FDIC, in conjunction with the other Federal banking agencies, will consider whether the existing regulatory leverage ratios should be left in place. If the agencies decide to retain a

leverage requirement, the FDIC also will consider whether the definition of capital for leverage purposes should be revised to conform to the definition of capital used for risk-based capital purposes.

The proposed risk-based capital framework sets forth: (1) a definition of capital for risk-based capital purposes; (2) a system for calculating risk-weighted assets by assigning risk weights to balance sheet assets and off-balance sheet items; and (3) a schedule, including transitional arrangements, for achieving a minimum supervisory target ratio of capital to risk-weighted assets.

The risk-based capital ratio focuses principally on broad categories of credit risk. However, the ratio does not take into account many other factors that can affect a banking organization's financial condition. These other factors include overall interest rate risk exposure; liquidity, funding and market risks; the quality and level of earnings; investment or loan portfolio concentrations; the quality of loans and investments; the effectiveness of loan and investment policies; the level and severity of problem and adversely classified assets; and management's overall ability to monitor and control other financial and operating risks. For this reason, the final supervisory judgment on a banking organization's capital adequacy may differ significantly from the conclusions that might be drawn solely from the organization's minimum risk-based capital ratio.

The risk-based capital framework would apply to all international banking organizations. The ratios in the proposal have been established with a view toward maintaining a safe and sound banking system rather than achieving the lowest common denominator. There are competitive equity concerns in light of the fact that investment banks, savings and loan associations and nonbank financial intermediaries would not be subject to the risk-based capital framework. However, efforts will continue to eliminate or minimize competitive inequities among financial institutions of all types, to the extent that such action is consistent with a safe and sound banking system.

An important question with respect to international capital standards is whether they should apply only to banks (as they do in foreign countries), or to banks and bank holding companies as proposed in the United States. This is a difficult question since the United States is the only country which regulates holding companies. It is our view that competitive equity would be served by not subjecting holding companies to the new risk-based capital requirements.

A risk-based capital framework will not be finalized until after the Federal banking agencies have consulted further with banking regulators from other countries and carefully evaluated the public comments received in response to the current proposal.

Some of what appears as new equity in banks is the result of double-leveraging by holding companies. Double-leverage has been a potential cause for concern for several years. Thus, the FDIC analyzes double-leverage on a case-by-case basis during the examination of individual banks. Double-leverage occurs when the parent company incurs debt and uses the proceeds to purchase equity in its bank or nonbank subsidiaries. Since the normal practice is to service this debt through dividends from the subsidiaries, excessive debt service requirements of the parent can be a threat to the banks in the holding company. There have been a number of examples of bank holding company leveraging that have weakened the banks in the system.

Double leverage is an important issue in the pending legislation to restructure the financial services industry. If there is to be an effective firewall, we must be able to protect the bank from its holding company and holding company creditors. The FDIC emphasized this position in the recent statement of protection regarding First Republic of Dallas, Texas. All depositors and other general creditors of First Republic's banks are fully protected, but the FDIC made it clear that these guarantees DO NOT extend to the holding company creditors or shareholders. Furthermore, the assistance the FDIC provided First Republic was guaranteed by the holding company and its affiliate banks, and was collateralized by a pledge of certain assets of the holding company. The holding company banks were not allowed to pay dividends to service holding company debt.

Many multi-bank holding companies coordinate their banks' activities so closely that the bank holding company system effectively operates as a single banking enterprise. Yet when a bank within the system fails, the FDIC must deal with that bank as if it were independent. In effect, the FDIC must act as if there is no connection between the failed bank and the rest of the system unless it can take some action to prevent this result.

Some bank holding companies and their creditors have seen a way to turn this situation to their advantage. By concentrating poorer assets in a single bank, and then letting that bank fail, the bank holding company can shift the cost of those assets — the loss it would otherwise be forced to realize -- to the FDIC. This technique amounts to a misuse of the FDIC's resources, which can do substantial harm to the Federal safety net for depositors.

Recent experience also has shown that creditors and shareholders can impose unwarranted costs on the Federal safety net in other ways as well. In some cases, the FDIC arranges open-bank assistance transactions which avoid the disruption that bank failures inflict on communities. Open bank transactions may require the consent of creditors and shareholders of the holding company. However, in some situations creditors and shareholders have sought to "hold up" the transaction in an attempt to receive greater consideration than that to which they would have been entitled if the bank had failed. This imposes added costs on the Federal safety net.

We are seeking legislation that would allow us to meet this challenge. In fact, a draft legislative proposal was circulated to the members of this Committee last week. (A copy of the draft statutory language and an explanation is contained in Appendix B.) The proposal would establish a special emergency procedure to deal with failing banks that belong to multi-bank holding companies. The procedure would allow the FDIC — in conjunction with the Federal Reserve and the banks' primary regulators — to require the consolidation of a failing bank with other banks in the holding company. It is designed to improve the asset quality of a failing bank within a multi-bank system without affecting the health of the system as a whole.

We also would like to report on the status of capital in FDIC-insured savings banks. As of year-end 1987, all FDIC-insured savings banks reported positive net worths, even when their outstanding net worth certificates were not taken

into account. This is an improvement over 1983 when 5 institutions with $11.5 billion in total assets reported negative net worths when their net worth certificates were not counted. Capital levels in savings banks have increased over the last 5 years due to improved earnings performance and conversions to a stock form of ownership. From 1982 to 1985, net worth certificates totaling $710 million were issued to 29 savings banks that were experiencing severe losses due to interest rate mismatches. At year-end 1987, three banks had remaining net worth certificates outstanding aggregating $315 million.

Earnings — In 1987 commercial banks had their worst year for profitability since the Great Depression. Commercial banks earned $3.7 billion, down nearly 80 percent from $17.5 billion earned in 1986. Their return on assets of 0.12 percent and return on equity of 2.02 percent were the lowest levels since 1934. A soaring loan loss provision, over 67 percent higher than 1986, fully accounted for the industry's year-to-year drop in earnings. Loan loss provisions attributable to the international operations of U.S. banks were $20.6 billion, $18 billion higher than a year earlier. Absent the extraordinary reserving for LDC loans, net income would have been roughly equal to the 1986 level.

Earnings performance ratios for commercial banks have not been consistent among asset size groups or geographic locations. The largest banks reported poor earnings for 1987 due to their sizable loss provisions for international credits. After the large money center banks are excluded, the results for those banks west of the Mississippi River are poorer than those east of the Mississippi. Poor economic conditions in the energy States and Farm Belt are the primary contributor to the West's poor results.

The Southwest Region is a major area of earnings weakness. The region's banking sector is operating at a loss, with 36 percent of the banks in the region unprofitable for 1987 and the return on assets a negative 0.64 percent. A persistent high level of problem assets, despite high levels of charge-offs, points to a continuation of this problem for the region. The region's earnings also are depressed by the effect of the lowest net interest margin in the country. The region's well-publicized S&L and economic problems influence the banks' cost of funds which, coupled with a weak loan demand and high levels of nonperforming assets, compresses the net interest margin.

There have been a variety of developments in recent years that make satisfactory earnings for the banking system as a whole more difficult to achieve. Among these are poor economic conditions in certain areas of the country, the tendency of the largest most creditworthy customers to access the credit markets directly, and intensified competition from nontraditional banking business. However, the outlook for the immediate future is cautiously optimistic.

Banks continue to be creative in developing new products and services to increase their sources of income. Significant fee income is being generated by letters of credit and swaps, markets which continue to grow dramatically. Fee income from securities underwriting and other services is growing and would provide additional sources of income should these markets be opened to banks. The FDIC believes the banking system can provide new services and that new bank powers will provide new opportunities for profit in a safe and sound manner. Of course, proper controls and appropriate surveillance by the regulators will be necessary.

Assets — Nonperforming assets at year-end 1987 are highest in the largest 25 banks and in the Southwest Region with 3.46 and 4.18 percent, respectively, of their total assets in nonperforming status. Insured commercial banks as a group have 2.11 percent of their total assets in nonperforming status as of year-end 1987. Problem assets (*i.e.*, assets subject to adverse classification by the regulators) reflect trends and concentrations similar to nonperforming assets, with problem assets being 1.16 percent of total assets in the largest 25 category and 1.95 percent of total assets in the Southwest Region. All insured commercial banks had 0.91 percent of total assets classified as problem assets at both year-end 1987 and 1986.

We believe that the asset quality problems have for the most part been identified and steps are being taken to reduce banks' risk exposure. However, recovery will be slow. There are further losses to be recognized in these acknowledged problem areas and the high levels of problem assets will remain until the economic conditions are markedly improved.

Bank exposure to LDCs continues to decline as a percentage of capital. During 1987, most major U.S. banks significantly increased their bad debt reserves against loans to lesser developed countries. The money-center banks have reserves against approximately 25-30 percent of their non-trade LDC exposures. The large regional banks took additional reserves or charge-offs and now have reserves covering approximately 50 percent of their non-trade LDC exposures. Based on the use of 25 percent of export income to service debt, this level of reserving appears reasonable for present conditions.

These increased bad debt reserves severely depressed earnings but had no major ramifications on the U.S. financial system. The large reserves probably have served to enhance the flexibility banks have in dealing with LDC debt. In that regard, the Mexico/U.S. Treasury backed bond swap was less successful then originally envisaged, but it hopefully will lead to other innovative approaches under the "menu of options" to deal with the situation. Perhaps the major effect of the reserve action is that it has bolstered the perception that the LDC problem is concentrated, more than ever, in a handful of the largest U.S. banking companies.

Asset growth, which was less than two percent during 1987, showed the smallest annual increase in almost 40 years. Banks experienced shrinkage in those loan categories suffering quality problems, i.e., agricultural, energy, commercial real estate, and international. These shrinkages were essentially offset by growth in home equity loans, which stood at $33 billion at year-end, and other consumer lending. Banks continue to strive to expand lending in these new areas. However, competition remains heavy. Banks realize the possible adverse affects of heavy concentrations of assets. Most strive to minimize this risk while continuing to serve their customers' legitimate credit needs.

New products and services are being developed to help spread this risk and to take advantage of commercial banks' strengths. "Securitization" is one such practice which allows banks to emphasize one of their strengths — being an efficient originator of loans. Securitization activities, initially used in the mortgage banking area, are now expanding into other markets. They provide banks with additional sources of revenue without the capital requirements and costs associated with the warehousing of loans. Securitization also allows diversification of portfolio by region and thus helps to avoid concentration problems such as those currently being experienced in the Southwest.

Liquidity — During the latter part of 1987 banks enjoyed a large inflow of deposits at lower interest rates. This resulted partially from the October stock market decline. Up until that time, banking sector deposits had increased at a steady, albeit slow, pace. However, 1987 fourth quarter deposits grew at an annualized rate of 11.7 percent.

Overall, sources of banks' funds appear stable and liquidity is adequate. However, in the Southwest Region, institutions with sizable amounts of uninsured deposits are vulnerable to sudden deposit outflows. As evidenced by First Republic, funding sources can be influenced by poor operating results and uncertain conditions. This demonstrates that market discipline by depositors and creditors still exists despite insurers actions to protect all depositors in large institutions. However, we believe that the potential trouble spots have been identified and the FDIC has shown it is willing and able to be a stabilizing influence when the need arises.

The FDIC was generally satisfied with the banking system's support of the securities market during the October stock market decline. We believe the banks' response was consistent with safe and sound banking practices and they were able to assist in providing liquidity where needed. This support can be shown by a fourth quarter surge in loan demand.

BANK SUPERVISION

Our supervisory efforts continue to be directed toward maintaining the safety and soundness of the banking system and protecting the insurance fund against unnecessary loss. In addition to supervising directly on the federal level some 8,000 insured state nonmember banks, we monitor the condition of approximately 6,000 national and state member banks and cooperate with the other federal and state regulatory authorities in their efforts to assure the safe and sound operation of these insured banks.

One of the FDIC's primary goals has been to increase the level of onsite supervision by reducing the time intervals between onsite examinations. After evaluating our overall examination projections in terms of staff resources, operative procedures and the appropriate level of onsite examination, we decided to move toward more frequent examinations. Our goal now is to have an onsite examination every 24 months for well-rated institutions (those rated 1 or 2) and an onsite examination every 12 months for problem and near problem institutions (those rated 3, 4 or 5). Obviously such a goal cannot be accomplished overnight, but we have made considerable progress. Currently, we are averaging once every 34 months for satisfactory banks, once every 23 months for marginal banks and about once every 19 months for problem banks.

We recently have initiated a new program for coordinating FDIC supervision with state supervision -- known as the Supervisors Annual Flexible Examination (SAFE) Program. Under this program the FDIC sets annual plans for supervisory activities with state authorities. It is a flexible program that emphasizes results. Basically, we envision treating many examinations conducted by state examiners as our own. These state exams would be placed on our examination cycle database, and would be counted as examinations by the FDIC for purposes of tracking adherence to our examination schedule guidelines. Where state examinations are accepted as our own, FDIC presence in these banks for full-scope examinations would be delayed -- possibly for up to an additional

two years for 1 and 2-rated banks, and an additional one year for 3-rated banks. In the case of 3-rated banks, our presence would depend on trends in the individual banks.

At year-end 1987, the FDIC employed roughly 1900 field bank examiners. We intend to increase this number to about 2100 by the end of 1988. Our examiner force had declined to only 1389 in 1984 from the previous high of 1760 examiners in 1978 when we had only 342 problem banks and 7 bank failures. In contrast, there are currently over 1,500 problem banks and a possibility of up to 200 failures this year. Once we reach our goal of 2,100 we will decide whether we should expand our force further or remain at that level.

We have changed our recruiting methods and standards since deciding in 1985 and 1986 to increase the field staff by 30 percent. By improving our recruitment techniques and hiring the best possible candidates, we were able to hire 421 new trainee examiners in 1987 with a collective college grade point average of 3.4 out of a possible 4.0. It will be some time before these new people are sufficiently trained to be able to carry a full load of responsibility. We are building a new training center at Virginia Square, Virginia, to improve our ability to train our field forces as well as those employed by the states.

Even though we are not at our goal for examination frequency, the expanded work force has enabled us to complete more examinations in 1987 than in 1986. The number of safety and soundness examinations increased 14 percent and compliance examinations increased 60 percent during the past year. The need for effective supervision becomes even more critical as banks obtain expanded powers and undertake to engage in various nontraditional activities. Effective supervision also is a necessity in limiting the federal insurance safety net to banks and not allowing it to expand to bank holding companies.

A major innovation in our examination program has been the expanded use of automation and personal computers. We developed an automated examination report that is now utilized for all safety and soundness, trust, compliance and EDP examinations. Additionally, several specialty programs are available to assist our examiners with tasks ranging from APR calculations in consumer compliance examinations to analyses of capital adequacy. Personal computers have given our field staff immediate access to the data on the Corporation's mainframe computer and the tools to present current data in typewritten or graphic form. The automated report also provides the means to more accurately gauge overall time utilization and productivity trends.

FAILED AND PROBLEM BANKS

The condition of the banking system is generally sound although there continue to be areas of strain. Bank failures are at record levels. In 1987, 184 FDIC-insured banks failed and another 19 received financial assistance to avert failure, including 11 in the BancTexas group. Unfortunately, we have been setting new records each year, and this year is not expected to be an exception. As of April 30, there have been 59 failures and 13 assistance transactions which, inclusive of the First City and First Republic transactions, involve approximately 140 banks. This rate is about on a par with last year's but with more assistance transactions in the current mix. If the current pace continues, we can anticipate about 200 failures and assistance

transactions this year as well. It should be noted that almost 90 percent of these failures were west of the Mississippi River and banks in Texas alone accounted for over 30 percent of all bank failures so far this year.

Although the trend is finally downward, the number of problem banks also is near the record level. As of April 30, 1988, there were 1505 FDIC-insured problem banks with total deposits of $289 billion, down from 1,575 as of year-end 1987 but still over the year-end 1986 number of 1484. In mid 1987, the number of problem banks peaked at 1624 with deposits of $300 billion. Of the problem banks, approximately 500 are agricultural banks and 158 are energy banks. Eighty nine percent of the banks on the current problem list are west of the Mississippi River and over 61 percent are in the 6 states of Colorado, Louisiana, Kansas, Minnesota, Oklahoma and Texas.

It is important to note that there is considerable turnover in the specific banks on the problem bank list. Since the number of problem banks peaked in mid-1987 there have been 461 banks added to the problem bank list and 580 deleted from the list through April 30 of this year. Of the 580 deleted, 155 were the result of closings or receipt of FDIC assistance, 79 were the result of mergers and 346 were the result of improvements. The decline in the number of problem banks is primarily attributed to two factors, gradual improvement in the agricultural areas of the country and merger activity, particularly in Texas. We expect the number of problem banks to decline slowly although problems will continue to be severe in those areas dependent on the energy sector.

The pattern of increases and decreases in the number of problem banks correlates with economic conditions. While much of the country and most sectors of the economy now are experiencing relative prosperity, the differences among areas are much wider than has been experienced historically. The areas west of the Mississippi River, with economies that are importantly based on energy, have pockets of severe recession or even depression. Most of the FDIC's problem banks today, and for the rest of 1988, are located in these distressed regions. The statistics contained in our Quarterly Banking Profile (Appendix A) indicate clearly the problems by geographic area.

Deficiencies in bank management and policy exacerbate the natural tendency for banks to suffer from weaknesses in the economy. Historically, inept or abusive management has been a primary cause of problem banks and this remains true today. Management's underwriting standards and credit judgments must remain prudent even when the economy is strong so that the impact of inevitable economic downturns is moderated.

Even though economic problems now are of greater importance than normal in explaining bank problems, management remains an important cause of most banks' difficulties. We do not hesitate to use our formal enforcement powers when circumstances warrant. In 1987, we initiated 91 insurance removal proceedings under Section 8(a) of the Federal Deposit Insurance Act, 130 cease and desist actions under Section 8(b) and 22 removal actions under Section 8(e). Numbers of these actions are down modestly from 1986 except in the case of Section 8(a) actions, which are higher due to including national and state member banks most of which are in the Southwest.

The downturn in agriculture and energy has been so severe and protracted that today, in these depressed areas of the country, many banks with good records

and acceptable management are having financial difficulties. As regulators, we are using new approaches in supervising these institutions. We believe that formal enforcement actions — while very useful and appropriate in many situations — are counterproductive in those cases where management is acceptable, the bank's problems are the result of adverse market conditions, and the prospects for recovery are good, given a reasonable economic cycle. The FDIC seeks to work cooperatively with the management of such banks in a joint effort to restore the financial stability of their banks.

Our Capital Forbearance program is an example of the approach which we believe has been useful and beneficial to both the FDIC and participating banks. As of April 30, 1988, the FDIC has approved 1[illegible] applications for capital forbearance, while denying 68. Of the 126 banks in the FDIC's capital forebearance program on March 31, 1988, 57 improved their primary capital ratio since being approved. There have been 27 banks which have been terminated from the capital forebearance program. Two of these institutions were removed because of improved financial condition and four others merged into healthier institutions. Six more of these banks failed and the remaining 15 were removed due to noncompliance with the capital plan.

Banks participating in the program outside the west and southwest are improving. Many banks in the program throughout the country also are making good progress. Restoring financial health does not occur overnight but we believe that this program is a sound approach, which is doing the job it was designed to do. We will be evaluating the program and measuring its results carefully in the future.

be stabilized or on the decline. With new products banks could further improve their safety and soundness.

We believe that addressing the FSLIC problem should entail an overview of the workings of the entire federal deposit insurance system. This issue is of great importance. Accordingly, we have formed a group of knowledgeable people from both within and outside the FDIC to study, and make recommendations in, this area. We have asked for input from all interested parties. We expect our study -- "A Federal Deposit Insurance System for the 90s" -- will be completed before year-end.

CONCLUSION

The banking industry is experiencing a stressful period of evolution. There are serious problems and challenges for banks, bankers the regulators and especially for the establishment of appropriate public policy by the Congress. The questions and problems are not easily answered but they can be managed. Mistakes may occur, but correcting and learning from mistakes is often better than inaction. Actions taken now will shape the health and worldwide competitiveness of U.S. banking into the next century. We look forward to cooperating with the Congress in whatever way possible to insure that the industry remains the safe and sound backbone of the U.S. economic system and a capable competitor in world markets.

TABLE 1

Number and total deposits of troubled (CAMEL rating of 4 and 5 and pre-CAMEL equivalents) institutions

TOTAL NUMBER OF FDIC-INSURED PROBLEM COMMERCIAL BANKS AND THRIFTS AND AGGREGATE TOTAL DEPOSITS BY YEAR (000,000 omitted)

Year-End	0 - $300 Million		$300 - 1,000 Million		Over $1 Billion		Total	
	#	Total Deposits	#	Total Deposits	#	Total Deposits	#	Total Deposits
4/30/88	1,444	$ 60,651	39	$ 21,789	22	$206,413	1,505	$288,853
1987	1,509	63,743	42	22,461	24	196,246	1,575	282,450
1986	1,412	55,289	46	24,348	26	191,683	1,484	271,320
1985	1,069	41,317	41	23,217	30	132,593	1,140	197,127
1984	778	31,031	38	20,129	32	134,949	848	186,109
1983	591	26,838	31	16,513	20	85,740	642	129,081
1982	332	12,759	21	10,119	16	34,460	369	57,338
1981	197	5,659	15	9,423	11	27,482	223	42,564
1980	206	4,599	7	4,860	4	12,185	217	21,644
1979	274	6,995	11	6,559	2	6,763	287	20,317
1978	322	8,404	14	7,668	6	48,069	342	64,142
1977	348	10,036	13	7,307	7	44,561	368	61,904
1976	361	11,286	10	6,037	8	41,830	379	59,153
1975	303	7,641	7	3,955	2	6,517	312	18,113
1974	177	4,525	5	3,116	1	1,420	183	9,061
1973	154	2,806	2	1,499	0	0	156	4,305
1972	189	3,141	3	2,192	0	0	192	5,333
1971	239	3,504	2	1,453	0	0	241	4,957
1970	251	3,613	0	0	1	1,076	252	4,689

Source: FDIC Problem Bank List.

TABLE 2
CLOSED BANKS
FDIC INSURED INSTITUTIONS
BY SIZE (000 omitted)

Year-End	0 - $300 Million		$300 - 1,000 Million		Over $1 Billion		Total	
	#	Total Assets	#	Total Assets	#	Total Assets	#	Total Assets
4/30/88	58	$2,010,411	1	$ 590,700			59	$2,601,111
1987	181	5,644,359	3	1,277,618			184	6,921,977
1986	136	4,787,971	1	561,013	1	$1,616,816	138	6,965,800
1985	116	2,851,969					116	2,851,969
1984	77	2,371,211	1	391,800			78	2,763,011
1983	43	1,954,397	1	778,434	1	1,404,092	45	4,136,923
1982	31	749,647	2	1,497,159			33	2,246,806
1981	7	103,626					7	103,626
1980	10	236,164					10	236,164
1979	10	132,988					10	132,988
1978	6	281,495	1	712,540			7	994,035
1977	6	232,612					6	232,612
1976	15	627,186	1	412,107			16	1,039,293
1975	13	419,950					13	419,950
1974	3	166,934			1	3,655,662	4	3,822,596
1973	5	43,807			1	1,265,868	6	1,309,675
1972	1	22,054					1	22,054
1971	6	196,520					6	196,520
1970	7	62,147					7	62,147

Source: FDIC Annual Reports

TABLE 3
OPEN BANK ASSISTANCE
FDIC INSURED FINANCIAL INSTITUTIONS
BY SIZE (000 omitted)

Year-End	0 - $300 Million		$300 - 1,000 Million		Over $1 Billion		Total	
	#	Total Assets	#	Total Assets	#	Total Assets	#	Total Assets
4/30/88	9	$514,193	2	$1,285,107	2	$41,200,000	13	$42,999,300(A)
1987	7	122,580			2	2,428,518	9	2,551,098(B)
1986	6	220,694	1	500,000			7	720,694
1985	2	197,879	1	413,948	1	5,277,472	4	5,889,299
1984			1	513,400	1	35,900,000	2	36,413,400
1983	2	390,000			1	2,500,000	3	2,890,000
1982	2	205,203	4	2,642,682	3	6,537,724	9	9,385,609
1981			1	899,029	2	3,856,405	3	4,755,434
1980					1	5,500,000	1	5,500,000
1979								
1978								
1977								
1976			1	305,000			1	350,000
1975								
1974								
1973								
1972					1	1,300,000	1	1,300,000
1971	1	9,300					1	9,300
1970								

Source: FDIC Annual Reports

(A) Includes the 70 banks of First RepublicBank Corporation and the 52 banks of First City Bancorp System as one institution each.

(B) Includes the 11 banks of BancTexas System as one institution.

TABLE 4
CLOSED BANKS AND OPEN BANK ASSISTANCE BY FDIC
FDIC INSURED INSTITUTIONS
BY SIZE (000 omitted)

Year-End	0 - $300 Million		$300 - 1,000 Million		Over $1 Billion		Total	
	#	Total Assets	#	Total Assets	#	Total Assets	#	Total Assets
4/30/88	67	$2,524,604	3	$1,875,807	2	$41,200,000	72	$45,600,411(A)
1987	188	$5,766,939	3	$1,277,618	2	2,428,518	193	9,473,075(B)
1986	142	5,008,665	2	1,061,013	1	1,616,816	145	7,686,494
1985	118	3,049,848	1	413,948	1	5,277,472	120	8,741,268
1984	77	2,371,211	2	905,200	1	35,900,000	80	39,176,411
1983	45	2,344,397	1	778,434	2	3,904,092	48	7,026,923
1982	33	954,850	6	4,139,841	3	6,537,724	42	11,632,415
1981	7	103,626	1	899,029	2	3,856,405	10	4,859,060
1980	10	236,164			1	5,500,000	11	5,736,164
1979	10	132,988					10	132,988
1978	6	281,495	1	712,540			7	994,035
1977	6	232,612					6	232,612
1976	15	627,186	2	762,107			17	1,389,293
1975	13	419,950					13	419,950
1974	3	166,934			1	3,655,662	4	3,822,596
1973	5	43,807			1	1,265.868	6	1,309,675
1972	1	22,054			1	1,300,000	2	1,322,054
1971	7	205,820					7	205,820
1970	7	62,147					7	62,147

Source: FDIC Annual Reports

(A) Includes the 70 banks of First RepublicBank Corporation and the 52 banks of First City Bancorp System as one institution each.

(B) Includes the 11 banks of BancTexas System as one institution.

APPENDIX A

The FDIC Quarterly Banking Profile

L. William Seidman, Chairman

Fourth Quarter 1987

COMMERCIAL BANKING PERFORMANCE — FOURTH QUARTER, 1987

- *U.S. BANKS POST LOWEST RETURNS SINCE THE GREAT DEPRESSION*
- *1987'S EXTRAORDINARY LOAN LOSS PROVISIONS ACCOUNT FOR DROP IN PROFITS*
- *MIDWESTERN BANKS SHOW SIGNIFICANT IMPROVEMENT*
- *SOUTHWESTERN BANKS SUFFER LARGE LOSSES*
- *FOURTH QUARTER OPERATING INCOME UP SHARPLY FROM YEAR-EARLIER LEVELS*
- *NUMBER OF BANKS ON PROBLEM LIST DECLINES — FIRST TIME SINCE 1981*
- *SIGNIFICANT IMPROVEMENT IN INDUSTRY PERFORMANCE EXPECTED IN 1988*

Commercial banks earned $3.7 billion in 1987, down nearly 80 percent from the $17.5 billion earned in 1986, in their worst year for profitability since the Great Depression. Their return on assets of 0.13 percent and return on equity of 2.56 percent were the lowest levels since 1934. These results had been anticipated since the second quarter, when the nation's largest banks began setting aside sizable reserves for troubled loans to developing countries (LDCs). The soaring loan-loss provisions, over 67 percent higher than in 1986, fully accounted for the banking industry's year-to-year drop in earnings. Loan-loss provisions attributable to the international operations of U.S. banks were $20.6 billion, $18 billion higher than a year ago. Absent the extraordinary reserving for LDC loans, aggregate loan loss provisions would have declined $3 billion from a year ago, and net income would have been roughly equal to 1986's level.

Chart A — Returns on Assets and Equity at Insured Commercial Banks 1935—1987

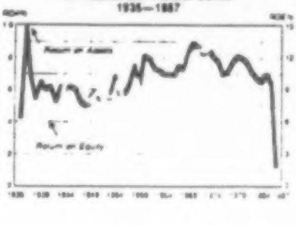
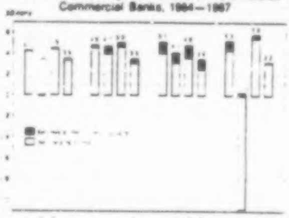


Chart B — Quarterly Net Income of FDIC-Insured Commercial Banks, 1984—1987



The loan-loss provisions had the positive effect of raising the aggregate allowance for loan and lease losses 71 percent. At year-end, the ratio of the loss allowance to loans stood at 2.70 percent, compared to 1.65 percent at the end of 1986. The ratio of equity capital to assets fell by 16 basis points to 6.05 percent, while the ratio of primary capital (which includes the loss allowance) to assets increased by 47 basis points to 7.69 percent. Nonperforming assets were up 29 percent from a year ago, largely due to the impaired status of LDC loans, ending the year at 2.58 percent of total assets. Most of the growth in nonperforming assets took place in the first quarter of the year; nonperforming assets shrank by $1.5 billion in the fourth quarter. The possibility that some nonaccruing LDC loans may return to accrual status in 1988 increases the potential for further reductions.

FDIC
Office of Research
& Strategic Planning

John [illegible]
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Ross Waldrop
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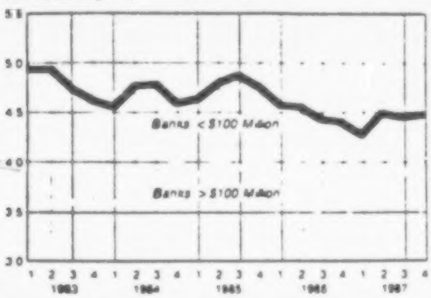
Fourth quarter operating income was $3.2 billion, up over 25 percent from the fourth quarter of 1986, despite loan loss provisions of $7.7 billion that were nearly 12 percent higher than the year-ago period. Interest margins, which narrowed for the full year, improved slightly during the second half of the year. They were especially strengthened in the fourth quarter in the wake of the October stock market decline, as banks enjoyed a large inflow of deposits and interest rates fell. Banking sector deposits, up only 2.2 percent for the year, grew at an annualized rate of 11.7 percent in the fourth quarter. The events of Black Monday also triggered a surge in loan demand as financial services firms sought to maintain liquidity. The largest banks were the greatest beneficiaries of the flight to quality; they also experienced a marked increase in noninterest income in the fourth quarter, especially from foreign exchange operations.

Chart C — Quarterly Net Interest Margins 1983—1987



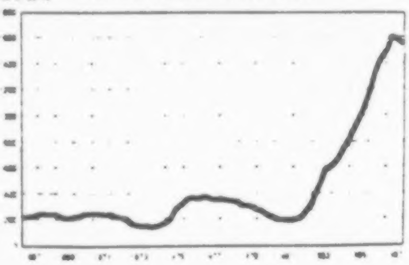
Asset growth was less than two percent during 1987, the smallest annual increase since 1948, and commercial loans were down two percent from year-earlier levels. The four percent growth in total loans was driven by increased real estate and consumer lending. Real estate loans outstanding at year-end actually exceeded banks' commercial loans by $10 billion, reflecting the restructuring of banks' traditional operations in the face of increased competition. Much of the increase in real estate lending was in the form of home equity loans, which stood at nearly $33 billion at year-end.

The outlook for 1988 is cautiously optimistic. Barring any new shocks, loan loss provisioning should be lower than usual this year, and profitability at money-center and regional banks will be much improved. The effectiveness of banks' efforts to expand noninterest income sources and curb operating expense growth will be an important determinant of profitability. Community banks showed improved results in 1987, with return on assets up 43 basis points at banks smaller than $100 million, and 22 basis points for banks in the $100-to-300 million range. Unaffected by overseas loan problems, both of these size groups, representing 93.5 percent of all banks, saw charge-offs and loss provisions decrease by 10 to 25 percent from year-earlier levels. Smaller banks outside the Southwest should continue to show strong or improving earnings in 1988.

The Southwest will continue to be a major source of earnings weakness. The levels of problem banks and failures remain high and the region's banking sector continues to operate at a loss. For the full year, 36 percent of the banks in the region were unprofitable and return on equity was a negative 11.81 percent. Persistent growth of nonperforming assets, despite high levels of loan charge-offs, points to more of the same this year. In contrast, the worst of the problems experienced by banks in the Midwest are behind them, and they can be expected to return soon to more traditional levels of profitability. The number of Midwest bank failures was down slightly, from 48 to 40, but the number of unprofitable banks was almost cut in half. Loan charge-offs declined 22 percent compared to 1986, while at the same time, asset quality improved, as nonperforming assets fell 6.5 percent. Midwestern banks showed the greatest improvement over 1986 results, with a 78 percent increase in net operating income on a year-to-year basis.

The results for the Northeast and, to a lesser extent, the Central and West regions, were dominated by the loan-loss provisioning at the big money-center banks. Actions by the largest banks overshadowed generally strong performance by banks in the Central region. Loan loss provisions were almost twice 1986 levels, halving net income, but actual loan losses grew by only five percent. The Central region had the lowest proportions of both failed and unprofitable banks, and the second highest rate of loan growth. The Southeast enjoyed the strongest loan demand of the six regions, as loans grew 11.3 percent and assets by 6.5 percent. That demand, combined with strong net interest margins, yielded a regional-high return on assets of 0.93 percent.

Chart D — Number of Insured Commercial Banks on the FDIC "Problem List"



The number of banks with full-year earnings losses fell 15 percent to 2,366 in 1987, while the number of "Problem" banks leveled off, after peaking at mid-year. On the whole, the number of banks on the "Problem List" increased by 102, 7.0 percent higher at the end of 1987 than 1986. This increase was the lowest, both in number of net additions and in percentage terms, since 1981. The outlook for 1988 is for fewer troubled institutions, but the number of failures is not expected to be significantly lower than 1987's record. Industry profits for 1988 should be close to the $17.5 billion earned in 1986, as banks return to a more normal pattern of operations.

Table I. Aggregate Condition and Income Data, FDIC-Insured Commercial Banks

(dollar figures in millions)

	Preliminary 4th Qtr 1987	3rd Qtr 1987	4th Qtr 1986	% Change 86:4-87:4
Number of banks reporting	13,654	13,851	14,200	-3.8
Total employees (full-time equivalent)	1,564,865	1,564,142	1,563,057	-0.5
CONDITION DATA				
Total Assets	$2,998,428	$2,942,652	$2,941,082	1.9
Real estate loans	599,135	579,046	515,365	16.3
Commercial & industrial loans	588,971	580,375	600,878	-2.0
Loans to individuals	350,361	341,829	335,698	4.4
Farm loans	29,317	31,066	31,607	-7.2
Other loans and leases	259,909	265,778	273,102	-4.8
Total loans and leases	1,827,693	1,798,094	1,756,650	4.0
LESS: Reserve for losses	49,429	47,407	28,903	71.0
Net loans and leases	1,778,264	1,750,687	1,727,747	2.9
Temporary investments	450,623	446,390	463,627	-2.8
Securities over 1 year	396,452	387,372	357,523	10.9
All other assets	373,089	358,203	392,185	-4.9
Total liabilities and capital	$2,998,428	$2,942,652	$2,941,082	1.9
Noninterest-bearing deposits	479,073	450,361	532,347	-10.0
Interest-bearing deposits	1,853,600	1,816,254	1,751,121	5.9
Other borrowed funds	361,351	367,418	358,964	0.7
Subordinated debt	17,586	17,528	16,993	3.5
All other liabilities	105,554	110,675	99,411	6.2
Equity capital	181,264	180,416	182,246	-0.5
Primary Capital	234,471	231,492	214,304	9.4
Nonperforming assets	74,390	75,914	57,667	29.0
Loan commitments and letters of credit	792,136	773,589	751,859	5.4
Domestic office assets	2,572,769	2,519,010	2,532,352	1.6
Foreign office assets	425,649	423,642	408,730	4.1
Domestic office deposits	1,991,066	1,922,217	1,969,673	1.1
Foreign office deposits	341,607	344,398	313,795	8.9
Earning Assets	2,625,339	2,584,449	2,548,897	3.0

INCOME DATA	Preliminary Full Year 1987	Full Year 1986	% Change	Preliminary 4th Qtr 1987	4th Qtr 1986	% Change
Total interest income	$244,695	$237,806	2.9	$64,270	57,865	11.1
Total interest expense	144,810	142,824	1.4	38,392	33,593	14.3
Net interest income	99,885	94,982	5.2	25,878	24,272	6.6
Provisions for loan losses	36,965	22,075	67.5	7,725	6,924	11.6
Total noninterest income	41,490	35,890	15.6	12,070	9,852	22.5
Total noninterest expense	96,933	90,247	7.4	25,691	24,196	6.2
Applicable income taxes	5,425	5,268	2.6	1,381	494	179.6
Net operating income	2,052	13,262	-84.5	3,151	2,510	25.5
Securities gains, net	1,436	3,950	-63.6	42	961	-95.6
Extraordinary gains, net	219	274	-20.1	38	61	-37.7
Net income	3,707	17,486	-78.8	3,231	3,532	-8.5
Net charge-offs	15,901	16,550	-3.9	5,253	5,448	-3.6
Net additions to capital stock	2,506	3,244	-22.7	1,392	2,251	-38.2
Cash dividends on capital stock	10,620	9,228	15.1	3,650	3,245	12.5

Table II. Selected Indicators, FDIC-Insured Commercial Banks

	1981	1982	1983	1984	1985	1986	1987
Return on assets	0.78%	0.71%	0.66%	0.65%	0.70%	0.64%	0.13%
Return on equity	13.08	12.11	10.70	10.73	11.31	10.18	2.56
Equity capital to assets	5.83	5.87	6.00	6.15	6.20	6.21	6.05
Primary capital ratio	6.39	6.47	6.59	6.91	6.91	7.22	7.69
Nonperforming assets to assets	N/A	1.85	1.97	1.97	1.87	1.96	2.46
Net charge-offs to loans	0.37	0.56	0.67	0.76	0.84	0.99	0.89
Asset growth rate	9.36	8.12	6.75	7.11	8.86	7.62	1.95
Net operating income growth	7.80	-0.62	-3.69	3.40	6.30	-16.20	-84.53
Number of unprofitable banks	741	1,195	1,530	1,881	2,453	2,784	2,366
Number of problem banks	196	325	603	800	1,098	1,457	1,559
Number of failed/assisted banks	7	34	45	78	118	144	201

N/A — Not available

A somewhat similar program (loan loss deferral) was authorized for agricultural banks by Congress last year. It is too early to determine the success of this program. However, as of April 30, 1988, 62 banks have applied for the program, with 15 applications approved, 10 denied and the remainder still under review.

With regard to the role of fraud and insider abuse in bank failures, we believe that such misconduct contributed significantly to about one-third of the bank failures in 1986, 1987 and so far in 1988. Outright criminal conduct was responsible for 12 percent to 15 percent of bank failures. For example, from January 1985 through 1987, 98 of the 354 banks that failed were cited by examiners as having at least some element of fraud or insider abuse. Those 98 failed banks had assets of $2.7 billion and cost the FDIC nearly $676 million. Our experience since 1985, however, suggests a somewhat lessened impact of fraud and abuse compared to the late 1970s and early 1980s.

The FDIC recognized a need to strengthen efforts to deal with fraud and abuse and has taken several major steps since 1984 to improve the situation. We published a list of time tested "Red Flags" and other warning signs of fraud and abuse to be used as an aid to examiners and auditors. We designated some 80 examiners as bank fraud specialists to be given specialized training in bank fraud and insider abuse. Later this year, an intensive, highly specialized training session will be held for these examiners. It will focus on criminal motivation, early detection and investigative techniques. Other training courses for examiners and liquidators have been developed or improved.

We have published guidelines for banks to use in setting up or revising their codes of conduct and, earlier this year, we mailed to all of the banks under

our supervision our Pocket Guide for Directors, a copy of which is attached as Appendix C. The Guide provides directors with practical guidance in meeting their duties and responsibilities.

These initiatives with respect to the bank fraud problem will help contain this ever-present problem by fostering public confidence and deterring future abuses.

FAILING BANK RESOLUTION AND LIQUIDATION ACTIVITIES

The FDIC is constantly seeking innovative ways of efficiently resolving failing bank cases and meeting our deposit insurance commitments. In light of the record number of bank failures over the past few years, we have been especially concerned that we maintain our sound cash position. This objective requires the prompt resolution of failing bank cases in a manner that minimizes our costs and cash outlays and results in the FDIC acquiring as few bank assets as possible. Thus, we are actively pursuing, whenever possible, whole bank transactions where the new owners of a failing or failed bank recapitalize the bank and assume all or substantially all its assets with the smallest possible contribution from the FDIC. This approach permits us to realize maximum value on the assets of the failed or failing bank, with only minimal disruption to existing borrower and depositor relationships and the community at large. In addition, as part of our SAFE cooperative program with state regulators we have arranged to give purchasers up to four weeks to examine a failing bank and decide whether they want to purchase it on an open or closed basis.

In keeping with our desire to conserve cash while maximizing our recoveries on acquired assets, we have developed new initiatives to obtain maximum net present value from liquidation assets in the shortest possible time. These initiatives include an aggressive marketing program -- including bulk sales -- designed to move loans and other assets back into the private sector; a stepped up management review of assets in litigation and large dollar assets; and an increased emphasis on seeking settlement on outstanding claims whenever practical rather than pursuing protracted litigation. However, we do not "dump" assets below current appraised values.

As a result of these initiatives, we were able to collect $2.4 billion by liquidating assets from failed banks last year, a 38 percent increase over the $1.7 billion collected in 1986. These efforts have enabled us to hold our inventory of managed assets from failed banks steady at about $11 billion despite a record number of bank failures with even greater record numbers in terms of dollars of failed assets involved.

With regard to the "too big to fail" problem, we suggest that the answer depends in part on how one defines the "problem." It may be that governmental protection of the largest banks in different countries is a premise which, in the United States, tends to be defined in terms of the extent of deposit insurance protection. Certainly, our experience to date in resolving several large failing bank cases suggests that the costs and dislocations of failing to fully protect certain bank depositors and creditors appear unacceptable. Since this appears to us to be the case with regard to banks over a certain size — that is, depositor losses in such banks threaten the stability of a region or possibly the entire banking system — then we must seek instead to consider how to extend comparable protection to smaller institutions.

Appendix D provides some thoughts on various alternatives, all of which unfortunately have some undesirable side effects. Certainly the greatest threat to the sufficiency and viability of the deposit insurance fund is posed by the largest banks that might be considered "too large to fail." If depositors in these banks are to be fully protected, there would seem to be relatively little more cost to the fund in extending that protection to smaller banks as well. However, this would further reduce the market's ability to discipline the system and thus could further increase the burden of government supervision. As yet, we have found no alternative which satisfies the criteria of providing a level playing field between larger and smaller banks, maintains what is left of depositor discipline and protects our system when big banks fail.

As a matter of policy, and consistent with statutory criteria, we are attempting to resolve smaller failing bank cases in a manner that protects all depositors whenever possible. This approach tends to minimize some of the perceived disparate treatment between large and small banks. By attempting to extend full protection to depositors of smaller banks we also tend to reap the full benefits of stability to the banking system that such an approach entails. In a relatively small number of cases, however, we have no choice under current law but to pay off insured depositors up to the statutory maximum. The losses of uninsured depositors in these cases amounted to only a little more than $80 million last year, or less than 99 percent of the total deposits of all failed banks and banks receiving open bank assistance.

When considered as a whole, our treatment of large and small failing banks is in most important respects remarkably similar. In virtually all cases, equity holders and subordinated creditors are substantially wiped out or suffer severe losses and senior management and directors are replaced. Bank depositors and creditors receive ALL of their funds in the vast majority of cases. In fact in 1987, 72 percent of the failed bank's were handled by purchase and assumption transactions which assured all depositors 100 percent of their funds.

ADEQUACY OF THE FUND

The financial condition of the FDIC remains strong and stable despite a record number of bank failures and assistance transactions, including the second largest in our history in 1987. At year-end 1987, the insurance fund's net worth was $18.3 billion, a modest increase of roughly $50 million over the previous year. Based on current estimates of loss in 1988, including the loss on First Republic of Dallas, Texas, we may experience a small decrease in the net worth of the fund in 1988.

The composition of the fund is as important as the balance. At year end 1987, nearly 91 percent of the fund balance, or $16.6 billion, was represented by cash and liquid U.S. Treasury Securities. The amount of these liquid assets declined by only about $500 million in 1987 even though record demands were made upon our fund.

The preservation of our cash is largely the result of the innovation in handling failures which we mentioned previously. The flexibility and capacity represented by what is essentially cash is one reason we are confident that the FDIC fund remains adequate to handle any foreseeable problems in the banking system.

Even though the fund is strong and stable, it is not increasing at a rate commensurate with the growth in deposits. In 1986 the ratio of reserves to insured deposits dropped from 1.20 percent to 1.12 percent. This decline continued in 1987 to 1.10 percent. Until the number or size of bank failures declines from present historically high levels, it is difficult to foresee the ratio of insurance reserves to insured deposits increasing. Indeed, a further decline in 1988 is anticipated largely due to the continued economic problems west of the Mississippi.

FDIC - FSLIC

While we believe that the FDIC fund is sufficient to deal with problems in the banking system as we see them today, we do not have the financial capacity to function as insurer of commercial banks, and restore the solvency of the Federal Savings and Loan Insurance Corporation as well. If additional funds are required by the FSLIC in the future, we believe they should be supplied without endangering the financial condition and capacity of the FDIC. We do not believe a merger of the funds is desirable under current conditions. Despite this view, we are studying various suggestions with respect to a merger in the event the Congress decides such action is required. In addition, we have offered whatever assistance we can to the FSLIC in terms of administration, asset liquidation, developing supervisory policies and procedures, training or other operational assistance.

Although there are some problems in the banking industry, there is no inventory of operating FDIC-insured insolvent banks. The fund is adequate, and commercial bank problems — outside recognized troubled areas — appear to

Table III. Preliminary Fourth Quarter 1987 Bank Data *(Dollar figures in billions, ratios in %)*

		Asset Size Distribution						Geographic Distribution					
								EAST			WEST		
	All Banks	Less than $100 Million	$100-300 Million	$300-1,000 Million	$1-5 Billion	Greater than $5 Billion	Ten Largest Banks	Northeast Region	Southeast Region	Central Region	Midwest Region	Southwest Region	West Region
Number of banks reporting	13,654	10,891	1,876	535	268	74	10	1,079	1,916	3,042	3,230	2,860	1,527
Total assets	$2,998.4	$392.6	$302.8	$272.2	$589.6	$761.3	$679.9	$1,179.7	$405.5	$479.7	$208.4	$279.9	$444.2
Total deposits	2,332.7	350.5	266.1	226.4	455.1	536.4	498.2	865.0	323.2	387.1	163.7	229.3	364.1
% total banks	100.0%	79.8%	13.7%	3.9%	2.0%	0.5%	0.1%	7.9%	14.0%	22.3%	23.7%	20.9%	11.2%
Asset share (%)	100.0	13.1	10.1	9.1	19.6	25.4	22.7	39.3	13.5	16.0	7.0	9.3	14.8
Deposit share (%)	100.0	15.0	11.4	9.7	19.5	23.0	21.4	37.1	13.9	16.6	7.0	9.8	15.6
Number of unprofitable banks	3,478	3,055	287	78	35	21	2	180	418	375	746	1,288	471
Number of failed/assisted banks	50	46	2	2	0	0	0	1	0	1	14	26	8
Performance ratios *(annualized)*													
Yield on earning assets	9.86%	9.83%	9.84%	10.11%	10.46%	10.18%	10.48%	10.17%	9.79%	9.44%	9.83%	8.93%	10.20%
Cost of funding earning assets	5.89	5.34	5.35	5.58	5.92	6.23	7.14	6.53	5.45	5.56	5.56	5.61	5.31
Net interest margin	3.97	4.49	4.49	4.53	4.54	3.95	3.34	3.64	4.34	3.88	4.27	3.32	4.89
Net noninterest expense to earning assets	2.09	3.12	2.76	2.72	2.47	2.01	1.08	1.52	2.45	2.08	2.02	2.73	2.80
Net operating income to assets	0.42	0.24	0.62	0.51	0.40	-0.20	1.04	0.57	0.78	0.48	0.77	-1.08	0.42
Return on assets	0.43	0.23	0.63	0.53	0.41	-0.19	1.07	0.61	0.80	0.48	0.74	-1.12	0.42
Return on equity	7.14	2.65	8.15	7.56	6.32	-3.68	25.98	11.27	11.58	7.33	9.89	-18.02	7.42
Net charge-offs to loans and leases	1.15	1.55	1.16	1.21	1.32	1.75	0.39	0.71	1.14	1.10	1.99	2.43	1.31
Condition Ratios													
Loss allowance to loans and leases	2.70%	1.83%	1.50%	1.60%	1.85%	2.93%	4.65%	3.15%	1.38%	2.24%	2.21%	3.09%	3.13%
Nonperforming assets to assets	2.48	2.09	1.75	1.87	1.93	2.29	3.58	2.44	1.04	1.27	1.87	5.80	3.28
Equity capital ratio	6.06	8.61	7.62	6.98	6.41	5.11	4.24	5.43	6.81	6.53	7.46	6.07	5.77
Primary capital ratio	7.66	9.36	8.36	7.69	7.36	7.01	7.56	7.51	7.53	7.80	8.58	7.56	7.97
Net loans and leases to assets	59.31	51.10	58.61	60.91	63.08	61.21	59.19	59.61	60.14	57.56	53.15	53.90	66.96
Net assets repriceable in one year or less to assets	-7.28	-9.46	-7.73	-7.43	-8.21	-8.01	-4.06	-8.05	-12.11	-4.90	-13.67	-11.39	-3.28
Growth Rates *(year-to-year)*													
Assets	1.9%	4.0%	5.9%	7.7%	9.4%	8.4%	-1.8%	4.1%	6.5%	3.5%	1.0%	-7.3%	-2.2%
Earning assets	3.0	4.6	7.0	9.0	10.7	10.0	-1.3	5.1	7.6	4.1	1.4	-7.4	0.3
Loans and leases	4.0	6.9	10.4	12.0	14.9	9.3	-3.0	5.9	11.3	6.9	3.3	-8.4	-0.6
Loss reserve	71.0	10.7	18.8	21.0	43.5	98.8	140.7	123.8	18.0	65.6	16.9	19.7	63.5
Net charge-offs	-3.8	-33.4	-21.0	-1.4	42.9	113.4	-82.3	2.8	44.5	23.7	-13.4	-32.2	-6.2
Nonperforming assets	29.0	0.4	9.5	19.7	41.7	58.3	49.6	64.5	15.7	0.9	-6.5	31.5	7.7
Deposits	2.2	4.1	5.4	8.1	9.1	9.0	0.2	4.7	5.9	4.3	1.5	-7.0	-2.4
Equity capital	-0.5	4.2	8.8	8.6	11.7	0.8	-18.3	-2.7	10.3	-0.5	5.7	-12.1	-0.6
Interest income	11.1	4.3	8.0	11.5	25.4	24.9	14.6	19.9	11.6	9.0	4.5	-4.9	4.8
Interest expense	14.3	2.4	8.1	13.1	28.2	31.5	21.3	27.1	13.6	10.1	3.7	-4.4	4.0
Net interest income	6.6	6.6	10.1	9.5	22.0	15.8	2.4	8.8	9.2	7.6	5.5	-5.6	5.7
Loan loss expense	11.6	-37.1	-32.2	-2.5	39.2	157.0	-28.0	42.6	14.1	75.5	-28.9	-32.2	12.4
Noninterest income	22.5	4.3	6.5	8.8	38.8	23.8	45.2	44.3	15.5	20.8	-5.7	1.3	0.8
Noninterest expense	6.2	4.7	6.4	9.5	22.5	18.5	8.0	13.3	4.5	4.4	0.3	-0.1	0.6
Net operating income	25.5	N/M	163.9	25.2	-10.8	N/M	128.3	-3.0	33.9	-17.1	83.3	N/M	44.8
Net income	-8.5	N/M	75.2	-0.4	-29.3	N/M	89.5	-13.4	3.7	-28.5	28.7	N/M	7.4

REGIONS Northeast — Connecticut, Delaware, District of Columbia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Puerto Rico, Rhode Island, Vermont

Southeast — Alabama, Florida, Georgia, Mississippi, North Carolina, South Carolina, Tennessee, Virginia, West Virginia

Central — Illinois, Indiana, Kentucky, Michigan, Ohio, Wisconsin

Midwest — Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, South Dakota

Southwest — Arkansas, Louisiana, New Mexico, Oklahoma, Texas

West — Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, Nevada, Oregon, Pacific Islands, Utah, Washington, Wyoming

Table IV. Preliminary Full-Year 1987 Bank Data *(Dollar figures in billions, ratios in %)*

		Asset Size Distribution						Geographic Distribution					
								EAST			WEST		
	All Banks	Less than $100 Million	$100-300 Million	$300-1,000 Million	$1-5 Billion	Greater than $5 Billion	Ten Largest Banks	Northeast Region	Southeast Region	Central Region	Midwest Region	Southwest Region	West Region
Number of unprofitable banks	2,366	2,070	174	62	33	18	9	104	130	164	412	1,028	398
Number of failed/assisted banks	201	186	12	3	0	0	0	3	8	7	40	118	33
Performance ratios													
Yield on earning assets	9.53%	9.65%	9.58%	9.65%	9.62%	9.39%	9.36%	8.75%	9.54%	9.19%	9.65%	8.70%	9.83%
Cost of funding earning assets	5.64	5.22	5.17	5.23	5.34	5.73	6.62	5.23	5.17	5.36	5.45	5.38	5.10
Net interest margin	3.89	4.43	4.41	4.43	4.28	3.66	3.17	3.52	4.37	3.83	4.20	3.32	4.73
Net noninterest expense to earning assets	2.16	2.85	2.66	2.83	2.37	1.88	1.51	1.74	2.48	2.13	1.95	2.43	2.93
Net operating income to assets	0.07	0.53	0.75	0.62	0.53	-0.05	-0.80	-0.22	0.88	0.41	0.66	-0.66	-0.05
Return on assets	0.13	0.58	0.81	0.67	0.57	-0.50	-0.81	-0.13	0.95	0.45	0.66	-0.61	-0.01
Return on equity	2.56	6.70	10.81	9.59	8.77	-0.01	-16.29	-2.95	17.16	8.28	11.48	-11.81	-0.32
Net charge-offs to loans and leases	0.89	1.14	0.81	0.95	0.92	1.04	0.87	0.61	0.80	0.69	1.57	1.90	1.08
Growth Rates *(year-to-year)*													
Net charge-offs	-3.9%	-21.2%	-10.8%	16.1%	24.4%	40.6%	-26.9%	7.5%	34.8%	5.2%	-22.4%	-12.8%	-11.3%
Interest income	2.9	-1.2	3.3	6.0	11.3	11.6	3.8	10.2	5.1	1.2	-1.6	-11.5	-2.6
Interest expense	1.4	-5.7	-1.3	1.6	7.4	11.2	6.3	11.6	1.4	-1.9	-4.7	-12.9	-6.3
Net interest income	5.2	4.9	9.3	11.8	16.6	12.1	-1.1	7.7	9.8	6.0	2.8	-9.1	4.4
Loan loss expense	67.5	-23.8	-16.1	5.3	35.7	141.5	173.8	303.7	23.6	95.1	-19.2	-17.6	42.9
Noninterest income	15.6	10.5	11.5	13.0	22.9	18.7	23.6	27.3	11.5	18.1	12.4	4.5	2.0
Noninterest expense	7.4	6.2	9.0	10.7	15.5	15.9	9.1	12.8	7.0	5.8	4.1	-0.4	4.3
Net operating income	-94.5	51.0	28.5	13.6	-3.7	N/M	N/M	N/M	18.8	-42.3	77.6	N/M	N/M
Net income	-78.8	12.8	11.3	-0.9	-12.1	N/M	N/M	N/M	8.5	-45.5	-1.4	N/M	N/M

NOTES TO USERS

COMPUTATION METHODOLOGY FOR PERFORMANCE AND CONDITION RATIOS

All income figures used in calculating performance ratios represent amounts for that period, annualized (multiplied by the number of periods in a year).

All asset and liability figures used in calculating performance ratios represent average amounts for the period (beginning-of-period amount plus end-of-period amount plus any periods in between, divided by the total number of periods).

All asset and liability figures used in calculating the condition ratios represent amounts as of the end of the quarter.

DEFINITIONS

"Problem" Banks—Federal regulators assign to each financial institution a uniform composite rating, based upon an evaluation of financial and operational criteria. The rating is based on a scale of 1 to 5 in ascending order of supervisory concern. "Problem" banks are those institutions with financial, operational or managerial weaknesses that threaten their continued financial viability. Depending upon the degree of risk and supervisory concern, they are rated either "4" or "5".

Earning Assets—all loans and other investments that earn interest, dividend or fee income.

Yield on Earning Assets—total interest, dividend and fee income earned on loans and investments as a percentage of average earning assets.

Cost of Funding Earning Assets—total interest expense paid on deposits and other borrowed money as a percentage of average earning assets.

Net Interest Margin—the difference between the yield on earning assets and the cost of funding them, i.e., the profit margin a bank earns on its loans and investments.

Net Noninterest Expense—total noninterest expense, excluding the expense of providing for loan losses, less total noninterest income. A measure of banks' overhead costs.

Net Operating Income—income after taxes and before gains (or losses) from securities transactions and from nonrecurring items. The profit earned on banks' regular banking business.

Return on Assets—net income (including securities transactions and nonrecurring items) as a percentage of average total assets. The basic yardstick of bank profitability.

Return on Equity—net income as a percentage of average total equity capital.

Net Charge-offs—total loans and leases charged off (removed from balance sheet because of uncollectibility) during the quarter, less amounts recovered on loans and leases previously charged off.

Nonperforming Assets—the sum of loans past-due 90 days or more, loans in nonaccrual status and noninvestment real estate owned other than bank premises.

Primary Capital—total equity capital plus the allowance for loan and lease losses plus minority interests in consolidated subsidiaries plus qualifying mandatory convertible debt (cannot exceed 20 percent of total primary capital), less intangible assets except purchased mortgage servicing rights.

Net Loans and Leases—total loans and leases less unearned income and the allowance for loan and lease losses.

Net Assets Repriceable in One Year or Less—all assets with interest rates that are repriceable in one year or less plus assets with remaining maturity of one year or less minus all liabilities that are repriced or due to mature within one year of the reporting date. A positive value indicates that banks' income from assets is more sensitive to movements in interest rates than is the expense of their liabilities, and vice-versa for a negative value.

Temporary Investments—the sum of interest-bearing balances due from depository institutions, federal funds sold and resold, trading-account assets and investment securities with remaining maturities of one year or less.

Loan Loss Expense—the quarterly addition to the loan loss reserve that will keep the balance of the reserve adequate to absorb the quarter's anticipated loan losses.

Requests for copies of and subscriptions to the FDIC Quarterly Banking Profile should be made through the FDIC's Office of Corporate Communications, 550 17th Street N.W., Washington, D.C. 20429; telephone (202) 898-6996.

APPENDIX B

DRAFT--MAY 11, 1988

EMERGENCY CONSOLIDATIONS

Analysis

Many bank holding companies coordinate their banks' activities so closely that the bank holding company system effectively operates as a single banking enterprise. Yet when a bank within the system fails, the FDIC must deal with such bank individually. In effect, the FDIC must act as if there is no connection between the failed bank and the rest of the system.

Some bank holding companies and their creditors have seen a way to turn this situation to their advantage. By concentrating poorer assets in a single bank, and then letting that bank fail, the bank holding company can shift the cost of those assets--the loss it would otherwise be forced to realize on them--to the FDIC. This technique amounts to a misuse of the FDIC's resources, which can do substantial harm to the Federal safety net for depositors.

Recent experience has also shown that creditors and shareholders can interfere with the Federal safety net in other ways as well. In many cases it is in the best interest of the local community and of the banking system for the FDIC to arrange open-bank assistance transactions. These transactions are designed to avoid the disruption that a bank failure would inflict on a community. Open-bank transactions may require the consent of creditors and shareholders of the holding company, however. In a number of cases the creditors and shareholders have delayed these transactions in an attempt to receive greater consideration than they would have been entitled to if the bank had failed. These creditors and shareholders have imposed added costs on the Federal safety net because of the FDIC's desire to prevent the closing of the bank.

The bill seeks to address these problems by establishing a special procedure to deal with failing banks that belong to multi-bank holding companies. The procedure is designed to improve the asset quality of a failing bank within a multi-bank system without affecting the health of the system as a whole.

The process begins when a bank's charterer--State or Federal--notifies the FDIC that a bank is in danger of failing, and asks the FDIC to start the process. The FDIC then decides whether the special procedure will reduce the risk to the FDIC fund, or alternatively, whether local economic conditions are such that resort to the special procedure is justified. If so, the FDIC may then certify to the Federal Reserve Board that it is necessary for the Board to exercise the new special powers made available under the bill.

Upon making the certification, the FDIC may specify one of the following new powers for the Board to exercise:

--The Board can order the holding company to transfer the stock of one or more of its healthy banks to the failing bank;
--The Board can order the company to merge one or more of its banks into the failing bank;
--The Board can order the company to merge the failing bank into one or more of its healthy banks; and/or

--The Board may order the company to provide such assets or services to the failing bank as may be needed for the bank to continue to conduct its normal business operations--e.g., bank buildings or data processing services.

The FDIC's recommendation may specify that the Board may exercise some or all of these powers. The Board may only exercise the powers that the FDIC has specified. On the other hand, the FDIC cannot compel the Board to take the action that the FDIC has recommended.

The Board must make a reasonable effort to see that the transaction does not involve the transfer of more assets to the failing bank than the bank needs to regain its health, taking into account the circumstances of the case. The FDIC may recommend a transaction, and the Board may order it, even if the assets so transferred to the failing bank are not sufficient to restore the bank to solvency.

Before the FDIC may make any recommendation to the Board, the FDIC must provide advance notice of the proposed transaction to every charterer--State and Federal--of every bank that would be involved. Each charterer has 48 hours to object to the recommendation. If any charterer objects within that time, the FDIC may only issue the recommendation if the FDIC's board of directors acts unanimously.

The Board has complete control over the specifics of any transaction that it orders pursuant to the FDIC's recommendation. The Board controls the procedures and scheduling.

No party may challenge an order issued by the Board or any action required by the Board in connection with any such transaction. Anyone who may be harmed by a Board-ordered action can take advantage of the bill's compensation provisions, but may not prevent the transaction from going forward.

No private contract can prevent or interfere with a Board-ordered transaction. Conversely, if a court declines to enforce a private contract because doing so would interfere with such a transaction, the court's action will not disturb the contract rights of the parties as among themselves.

Anyone who believes that a Board-ordered transaction has diminished the value of any valid and enforceable debt the bank holding company or any subsidiary bank might owe him, or of any equity interest he may own in the bank holding company or in any subsidiary bank, can apply to the Board within thirty days and ask the Board to appraise the debt or the equity interest. The Board must determine the value of any such debt or equity. Then, if the person tenders the debt or equity to the FDIC, the FDIC must buy it at the appraised value. This procedure provides full compensation for anyone whose property rights may be harmed by a Board-ordered transaction. It is the only procedure available to claimants for seeking such compensation.

The appraisal-and-tender rights created by this Act are only available to independent owners of the debt or equity of the bank holding company or of an affiliated bank. The bank holding company itself and its affiliates are not given any such rights.

The appraisal-and-tender rights apply to any debt and any equity, but only to debt or equity that someone holds on or before the effective date of this Act. Anyone who acquires debt or equity after that date does not have appraisal-and-tender rights. There are two exceptions to the cut-off. A person who is owed money for goods or services that the bank holding company or bank has procured in the ordinary course of business may tender the debt to the FDIC no matter when the debt was incurred. In addition, a person who owns shares in a subsidiary bank may tender them to the FDIC no matter when he acquired them. This latter provision protects someone who has bought a minority share in an independent bank, and who continues to hold that share after the majority owners have sold their shares to a bank holding company.

A resulting bank may keep any branches or other offices it acquires as a result of a Board-ordered merger.

DRAFT--MAY 16, 1988

EMERGENCY CONSOLIDATIONS

SEC. ___. EMERGENCY CONSOLIDATIONS.--Section 5 of the Bank Holding Company Act of 1956 is amended by inserting new subsections (g) and (h) at the end thereof reading as follows:

"(g) EMERGENCY CONSOLIDATIONS; PREEMPTION OF STATE AND FEDERAL LAWS.--Notwithstanding any other provision of this Act, or of Federal or State bankruptcy laws, or of any other Federal or State law or of the constitution of any State, or of any contract or other instrument or security--

"(1) CONSOLIDATIONS REQUIRED.--Upon certifying to the Board that it is necessary for the Board to exercise the powers made available by this subsection (g), the Corporation may recommend that the Board:

"(A) Order a bank holding company to cause any or all of its affiliated banks to be reorganized as subsidiaries of a bank specified in subparagraph (11)(A);

"(B) Order a bank holding company to cause any or all of its subsidiary banks located in the same State as a bank specified in subparagraph (11)(A) to merge with, or to purchase the assets and assume the liabilities of, such bank;

"(C) Order a bank holding company to cause a bank specified in subparagraph (11)(A) to merge with, or to purchase the assets and assume the liabilities of, any or all of the bank holding company's other subsidiary banks that are located in the same State as such bank;

"(D) Order a bank holding company to contribute or transfer or provide to a bank specified in subparagraph (11)(A), or to require any of its subsidiaries to contribute or transfer or provide to any such bank, such assets or services as are customarily utilized by a bank in the conduct of its business or operations; or

"(E) Order a bank holding company to take any combination of actions specified in paragraphs (A) through (D).

"(2) BOARD POWERS.--

"(A) AUTHORITY.--

"(i) The Board shall have authority to compel any bank holding company to consummate a transaction recommended by the Corporation under paragraph (1). The Board may require the bank holding company and any subsidiary thereof to take such action in connection with any such transaction as the Board may deem necessary or appropriate.

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"(ii) Upon a determination that an emergency no longer exists, the Board may order any bank holding company subsidiaries which were reorganized as subsidiaries of a bank under subparagraph (A) of paragraph (1) to be organized as direct subsidiaries of the bank holding company. In no event shall the Board order such a restructuring to occur in less than thirty days from the date of its order.

"(B) PROCEDURES.--Any action required by the Board under subparagraph (A) shall be consummated in accordance with such procedures and schedules as the Board may prescribe. Except as provided in clause (ii) of subparagraph (A), any transaction ordered by the Board, and any action required by the Board in connection with any such transaction, shall be consummated immediately if the Board so orders.

"(C) JUDICIAL REVIEW.--No order issued by the Board under this paragraph (2), and no action required by the Board under this paragraph (2), shall be subject to review by any court.

"(3) CONSULTATION.--

"(i) REQUIRED.--Before making any recommendation under paragraph (1), the Corporation shall consult the relevant supervisor of any bank involved in the recommended transaction.

"(ii) NOTICE.--The Corporation shall provide the relevant supervisor a reasonable opportunity, and in no event less than forty-eight hours, to object to the Corporation's recommendation.

"(iii) RIGHT TO OBJECT.--If the relevant supervisor objects during such period, the Corporation may make a recommendation under paragraph (1) only by a unanimous vote of its Board of Directors.

"(4) OFFICES ACQUIRED IN CONSOLIDATIONS.--Any office operated as a branch or home office by a bank involved in a transaction ordered by the Board under paragraph (2) may be operated as a branch or home office by any bank that acquires it pursuant to such transaction.

"(5) APPLICATION OF CERTAIN LAWS.--

"(A) BANK HOLDING COMPANY ACT.--

"(i) SECTION 2.--So long as a bank that is ordered under paragraph (2) to acquire affiliates as subsidiaries remains itself a subsidiary of a bank holding company, the term 'bank holding company' is defined in subsection 2(a) of this Act shall not include a bank if such bank would otherwise be deemed to be a bank holding company solely because it holds stock in the shares of another bank or banks, and has acquired such stock pursuant to the action required by the Board.

"(ii) SECTION 3.--No action required by the Board under paragraph (2) shall require an application to or approval by the Board under Section 3 of this Act.

"(B) NATIONAL BANKING ACT.--No action required by the Board under paragraph (2) shall be subject to the requirements of the National Banking Act specified in Section 20 of Public Law 86-230.

"(C) FEDERAL DEPOSIT INSURANCE ACT.--No action required by the Board under paragraph (2) shall be subject to the requirements of section 13(f) or of section 18(c) of the Federal Deposit Insurance Act.

"(D) HART-SCOTT-RODINO ACT.--No action required by the Board under paragraph (2) shall be subject to the requirements of the Hart-Scott-Rodino Antitrust Improvements Act of 1976.

"(6) PRIVATE PARTIES INELIGIBLE TO PREVENT CONSOLIDATION.--

(A) LIMITATION ON RIGHTS OF PRIVATE PARTIES.--No court shall give effect to any rights or powers conferred on any person, whether such rights or powers are conferred by State or Federal statute or by the articles or by-laws of the bank holding company or of any subsidiary thereof or by any debt or equity security of any such bank holding company or subsidiary thereof or by any other contract or other instrument or otherwise, and any provision of any such statute or security or article or by-law or contract or instrument shall be void, insofar as giving effect to any such rights or powers would impair the ability of the bank holding company or of any subsidiary bank:

"(i) to take any action required by the Board under paragraph (2), or

"(ii) as part of a transaction ordered by the Board under paragraph (2), to pledge, sell or otherwise transfer securities or assets of the bank holding company or of any subsidiary bank to the Corporation in connection with a transaction authorized by Section 13 of the Federal Deposit Insurance Act.

"(B) REFUSAL TO ENFORCE RIGHTS NOT OCCASION OF DEFAULT OR OTHER IMPOSITION OF PENALTY OR GROUND FOR ASSERTION OF DERIVATIVE RIGHTS.--The failure of a court to give effect to any rights or powers under subparagraph (A) shall not constitute an event of default or occasion of imposition of any penalty. No consequent effect of such failure to enforce the rights or duties of any person shall constitute an event of default or occasion of imposition of any penalty. No person may assert any rights or powers, whether such rights or powers are conferred by State or Federal statute or by the articles or by-laws of the bank holding company or of any subsidiary thereof or by any debt or equity security of any such bank holding company or subsidiary thereof or by any other contract or other instrument or otherwise, if such person would be unable to assert such rights or powers but for the failure of the court to give effect to rights or powers under subparagraph (A).

"(C) NO OTHER CONSENTS NECESSARY.--Except as provided in this subsection (g), any action required by the Board under paragraph (2) shall be consummated without the necessity of notice to, approval from, or consent of shareholders, creditors, parties to contracts, lessors, insurers, or any other persons or governmental authorities.

"(7) RIGHT OF APPRAISAL.--

"(A) DEBTS OF BANK HOLDING COMPANIES AND OF AFFILIATED BANKS.--Any creditor of a bank holding company subject to an order issued by the Board under paragraph (2), and any creditor of a bank directly involved in a transaction in connection with such order, may apply to the Board for an appraisal of the value of any valid and enforceable debt owed to such creditor: provided, that neither the bank holding company nor any affiliate thereof, other than a person who is an affiliate solely because such person holds shares for investment purposes in such bank holding company or affiliate thereof, may file an application to the Board under this subparagraph (A).

"(B) SHAREHOLDERS IN BANK HOLDING COMPANIES.--Any person holding shares in a bank holding company subject to an order issued by the Board under paragraph (2) may apply to the Board for an appraisal of the value of such shares: provided, that no affiliate of such bank holding company, other than a person who is an affiliate solely because such person holds shares for investment purposes in such bank holding company, may file an application to the Board under this subparagraph (B).

"(C) SHAREHOLDERS IN AFFILIATED BANKS.--Any person holding shares in a bank directly involved in a transaction in connection with an order issued by the Board under paragraph (2) may apply to the Board for an appraisal of the value of such shares: provided, that no affiliate of such bank, other than a person who is an affiliate solely because such person holds shares for investment purposes in such bank, may file an application to the Board under this subparagraph (C).

"(8) TIME LIMITS.--

"(A) LIMIT RELATED TO TIME OF CONSUMMATION OF THE TRANSACTION.--No application under paragraph (7) may be made more than thirty days after the date of consummation of the transaction ordered by the Board under paragraph (2).

"(B) LIMIT RELATED TO TIME OF ACQUISITION OF THE DEBT OR SHARE.--No application under subparagraph (A) or subparagraph (B) of paragraph (7) may be made based on a debt or share acquired by the applicant on or after [the effective date of this Act]: provided, that this subparagraph (B) shall not apply to a person making application based on a debt owed for goods or services procured by the bank holding company or bank in the ordinary course of business.

"(9) BOARD APPRAISALS.--

"(A) BOARD AUTHORIZED TO MAKE APPRAISALS.--Whenever a person files an application with the Board under paragraph (7), the Board shall determine the value of any debt or share based upon an appraisal. The appraisal shall be final and binding on all parties.

"(B) BASIS FOR APPRAISAL.--The value of any debt or share shall be based upon the value it would have had if every bank specified in subparagraph (11)(A) had been closed on the date of the order issued by the Board under paragraph (2), with the Corporation paying all insured deposits, the assets liquidated, and the resulting funds applied toward satisfying all other valid and enforceable liabilities of such bank, with the remainder, if any, allocated to the shareholders of such bank. Any determination of value also shall include consideration of any consequential effects resulting from such closing that would have occurred to other subsidiaries of the bank holding company.

"(C) RULEMAKING AUTHORITY.--The Board shall promulgate rules providing the procedures for making applications and appraisals under this subparagraph (9).

"(D) STANDARD OF REVIEW FOR APPRAISALS.--Any person obtaining an appraisal from the Board and disagreeing with the appraisal so established may seek review of the appraisal in accordance with the provisions of section 9 of this Act: provided, that no appraisal of any debt or share shall be set aside unless the Board has acted arbitrarily and capriciously in setting the value of such debt or share.

"(10) FDIC COMPENSATION.--

"(A) TENDER BY APPLICANT.--No later than twenty days after completion of an appraisal under subparagraph (9)(A) and review of any challenge thereto, an applicant may tender to the Corporation any debt or share so appraised. An applicant may accomplish the tender by surrendering the debt instrument or share to the Corporation or by providing such other evidence of the debt or ownership interest as the Corporation may reasonably require.

"(B) FDIC COMPENSATION AUTHORIZED; SUBROGATION.--Upon tender of any debt or share under subparagraph (A), the Corporation is authorized and directed to acquire any such debt or share from the applicant and to compensate the applicant promptly in the amount determined by the Board under paragraph (9). Upon providing compensation to any person under this subparagraph (B), the Corporation shall be subrogated to all rights of such person arising out of such debt or share to the extent of such compensation.

"(C) RULEMAKING AUTHORITY.--The Corporation is authorized and directed to promulgate rules providing procedures for receipt and payment under the provisions of this paragraph (10).

"(D) FDIC COMPENSATION AS SOLE REMEDY.--The procedure established by this paragraph (10) shall be the sole means by which any person may seek compensation for any loss occasioned by an action ordered by the Board under paragraph (2).

"(11) STANDARD FOR CERTIFICATION.--The Corporation may certify that it is necessary for the Board to exercise the powers made available by this subsection (g) only if:

"(A) BANK IN DANGER OF CLOSING.--The chartering authority for an insured bank has notified the Corporation that the bank is in danger of closing, as defined in Section 13(f)(8) of the Federal Deposit Insurance Act, and

"(B) REDUCTION OF RISK TO FDIC FUND.--The Corporation has determined, in its sole discretion, either:

"(i) That such action will lessen the risk to the Federal Deposit Insurance fund, or

"(ii) That severe financial conditions exist which threaten the stability of a significant number of insured banks in the community where the bank specified in subparagraph (A) is located or is making loans or is doing business, or the stability of insured banks possessing significant financial resources in any such community.

"(12) BOARD ACTION TO BE LIMITED IN KEEPING WITH NEEDS OF SITUATION.--In exercising the authority conferred under this subsection (g), the Board shall make a reasonable effort to assure that any transfer of assets or securities to a bank specified in subparagraph (11)(A), and any transfer of assets or securities in connection with a merger involving a bank specified in subparagraph (11)(A), shall not exceed an amount that is reasonably necessary to provide adequate capitalization to such bank or any successor thereto.

"(13) DEFINITIONS.--For the purpose of this subsection (g):

"(A) FDIC.--The term 'Corporation' means the Federal Deposit Insurance Corporation.

"(B) RELEVANT SUPERVISOR.--

"(i) COMPTROLLER OF THE CURRENCY.--In the case of a national bank, the term 'relevant supervisor' means the Office of the Comptroller of the Currency.

"(ii) STATE BANK SUPERVISOR.--In the case of a State-chartered bank, the term 'relevant supervisor' means the State bank supervisor of any such bank.

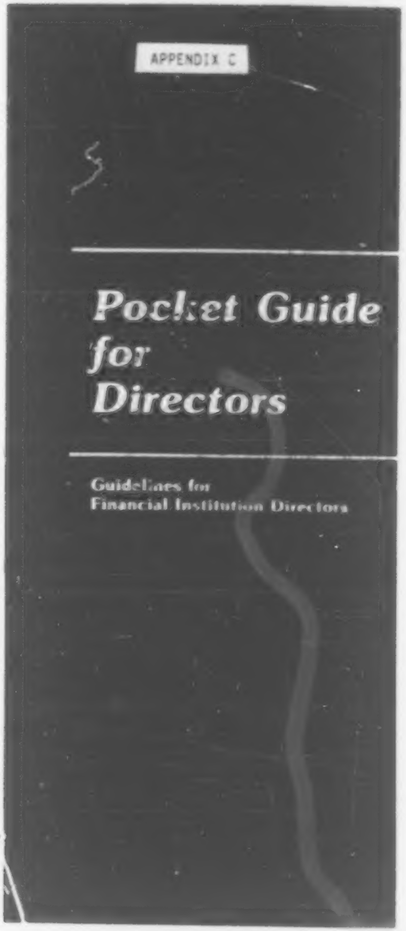
"(h)(1) CERTAIN RESTRICTIONS PROHIBITED.--No provision of any contract entered into by a bank holding company or subsidiary thereof on or after [the effective date of this Act] shall be effective if:

"(A) it prohibits or restricts in any manner the sale, transfer, pledge or conveyance by a bank holding company or a bank subsidiary of a bank holding company of shares or assets of a subsidiary bank or prohibits the subsidiary bank from selling, transferring, pledging or conveying any or all of its shares, assets or liabilities to any entity other than the holding company; and

"(B) such sale, transfer, pledge or conveyance takes place in conjunction with or as a part of assistance provided by the Corporation under section 13(c) of the Federal Deposit Insurance Act and the Corporation requests such sale, transfer, pledge or conveyance as a part of such assistance.

"(2) COMPLIANCE WITH FDIC REQUEST NOT OCCASION OF DEFAULT OR OTHER IMPOSITION OF PENALTY.--Any compliance with such a request of the Corporation shall not constitute a default or event of default under such contract, and shall not give rise to the imposition of rights of acceleration, damages, or otherwise.

"(3) DEFINITION.--For the purpose of this subsection (h) the term 'Corporation' means the Federal Deposit Insurance Corporation.



APPENDIX C

Pocket Guide for Directors

Guidelines for Financial Institution Directors

Financial Institution Directors

Change in the financial marketplace has created a more competitive and challenging environment for all financial institutions. As a consequence of this change, the role of the financial institution board member has grown in importance and complexity.

This Pocket Guide has been developed by the Federal Deposit Insurance Corporation to provide directors of financial institutions with accessible and practical guidance in meeting their duties and responsibilities in a changing environment. These guidelines have been endorsed by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency and the Federal Home Loan Bank Board.

We hope this Pocket Guide will help to make the director's job one that can be approached with clarity, assurance and effectiveness. If you are helped in meeting these goals, then the larger goal of maintaining confidence in the safety and soundness of our financial system will also be achieved.

Sincerely,

L. William Seidman
Chairman
Federal Deposit Insurance Corporation

Robert L. Clarke

C. C. Hope, Jr.

FEDERAL DEPOSIT INSURANCE CORPORATION
Washington, D.C.
February, 1988

General Guidelines

A financial institution's board of directors oversees the conduct of the institution's business. The board of directors should:

- select and retain competent management;
- establish, with management, the institution's long and short term business objectives, and adopt operating policies to achieve these objectives in a legal and sound manner;
- monitor operations to ensure they are controlled adequately and are in compliance with laws and policies;
- oversee the institution's business performance; and
- ensure that the institution helps to meet its community's credit needs.

These responsibilities are governed by a complex framework of federal and state law and regulation. The guidelines do not modify the legal framework in any way and are not intended to cover every conceivable situation that may confront an insured institution. Rather, they are intended only to offer general assistance to directors in meeting their responsibilities. Underlying these guidelines is the assumption that directors are making an honest effort to deal fairly with their institutions and to comply with all applicable laws and regulations, and follow sound practices.

The **Chairman**. Thank you, Chairman Seidman.

Governor Heller.

STATEMENT OF H. ROBERT HELLER, MEMBER, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. **Heller**. Thank you, Mr. Chairman.

I welcome the opportunity to appear before this committee on behalf of the Federal Reserve Board to discuss the condition of our Nation's banking system.

As a general rule, conditions in the banking system tend to mirror conditions in the economy and because we are now in the longest economic recovery in postwar history one might reasonably expect that the condition of the banking system would reflect that strength.

Unfortunately, this is not so because certain regions and sectors of our economy have been beset by serious structural problems over the last several years and the resulting problems for the banking system have been aggravated by restrictions on geographic expansion that have left a large segment of our banking industry vulnerable to local and regional economic problems.

Thus, despite a generally strong economic recovery, many financial institutions are under severe stress. Depressed conditions in the energy sector have resulted in enormous losses on energy loans and more recently on commercial real estate loans for banking institutions in the Southwest. Of the total of 2,870 banks in this region, 1,017 lost money last year. While progress is being made, we still have a way to go before the problems of the Southwest will be behind us.

Similarly, banks operating in the farm belt or serving agricultural communities have shared the distress of the agricultural sector. Fortunately, 1987 saw a turn for the better as the aggregate net worth of farmers increased for the first time since 1980 and this helped to relieve the pressure on banks serving farm communities.

Another area of concern which appears to have cut across regional boundaries is commercial real estate lending.

The international debt situation also affected income statements and balance sheets of many multinational and regional banking organizations. But despite setbacks, meaningful progress has been achieved and leaders in a number of foreign countries have recognized the need to restructure their economies by placing greater emphasis on the private sector.

PERFORMANCE OF THE BANKING INDUSTRY IN 1987

Let me address now the performance of the banking industry in 1987. I will focus on the areas identified in the committee's letter of invitation.

First, asset quality. As noted earlier, asset quality has been the greatest problem facing the industry. Last year, the ratio of nonperforming assets to total assets reached a postwar high and of all insured commercial banks this ratio rose from 1.6 percent in 1986 to 2.1 percent at the end of 1987.

The principal reasons for this increase were the placement of a large amount of LDC debt into nonaccrual status and the continuing energy and real estate problems in the Southwest.

The asset quality picture has a positive side, however, because if we set aside the effect of the LDC nonaccruals and the problems in Texas, we find that domestic asset quality as measured by nonperforming asset ratio actually improved last year.

Not surprisingly, the high level of problem assets have eroded the profitability of the banking industry in recent years. In 1987, the average return on assets for all insured commercial banks declined almost 50 basis points to 0.12 percent, and the average return on equity dropped a precipitous 750 basis points to 2.07 percent.

But these aggregate measures of industry profitability masked the disparities in the performance of banks in different regions of the country. The special LDC provisions taken last year caused significant losses or declines in earnings at the large multinational and regional institutions, and as I've indicated, many banks in States dependent on the agricultural and energy sectors continue to record poor results.

At the same time, however, many organizations, particularly those in regions where economic conditions have been favorable, reported good to strong earnings. This year, first quarter earnings reports have reflected an improvement over last year's depressed levels.

Although capital has long been an issue in the banking industry, it took on greater significance in 1987 because of the heavy losses sustained by many of the largest organizations. In 1987, the average ratio of equity capital excluding loan loss reserves to total assets for the 25 largest commercial banks declined from 5.1 to 4.3 percent, and that decline marks the reversal of 6 years of steady improvement.

The recent decline in equity capital ratios at our large institutions stemming from the LDC situation has also stirred understandable concern. But one of the principal functions of capital is precisely to absorb losses and to cushion other financial adversities.

We believe that the levels and trends of liquidity within the banking system are generally satisfactory.

The problems and conditions that I've described have resulted in a steady increase in the number of problem and failed banks since 1981. The number of institutions on the list of FDIC insured problem banks and thrift institutions rose from 223 in 1981 to 1,575 by the end of 1987. And of that total, over 95 percent had assets of less than $300 million and 88 percent were located where problems in the farm, energy and real estate sectors have been most acute. Sixty percent of all bank failures last year were located in only four States—Texas, Oklahoma, Louisiana and Colorado.

As these figures suggest, the problems have centered in States that historically have strictly limited branching and other forms of geographic expansions. In addition, Federal restrictions have prevented institutions from expanding across State lines. These limits have severely hampered our financial institutions in diversifying their portfolios and therefore have left them more vulnerable to sectoral and regional economic strains.

STEPS TAKEN BY THE FED

The Federal Reserve has taken steps over the last several years to strengthen its ability to identify and address problems in the banking system. These steps include more frequent on-site examinations, more frequent meetings between Federal Reserve officials and bank directors, improvements in techniques for communicating with managements and directors, strengthening of supervisory enforcement, expansion of cooperative examination arrangements with State banking examiners, and the enhancement of examiner training programs.

We have also tightened our standards for new banks to become members of the Federal Reserve System.

The Federal Reserve consistently stresses the role of capital in promoting the safety and soundness of our banking and financial system. Capital adequacy is particularly important in evaluating the proposals of bank holding companies to expand. The Board has long believed that banking organizations undertaking market expansions or large acquisitions should maintain strong capital positions well above minimal supervisory levels.

In addition, we have discouraged excessive or unwarranted increases in dividends by banking organizations whose capital positions need strengthening. In line with this emphasis on capital adequacy, the Board reaffirmed in April of last year its regulatory policy that bank holding companies should act as a source of strength to the subsidiary banks by standing ready to provide capital funds during times of financial stress.

The Federal banking agencies have also undertaken to strengthen supervisory standards for assessing capital adequacy through the development of the internationally accepted risk-based capital framework.

We believe that all these efforts will strengthen our banking institutions and will make them more resistant to financial pressures. In addition, Congress has a key role to play in establishing the appropriate legal framework. The Board strongly supports Senator Proxmire's Financial Modernization Act which will broaden the range of securities activities permissible for banking organizations by repealing the Glass-Steagall Act separation of commercial and investment banking.

And in addition, the serious problems experienced by banks in the Midwest and Southwest underscore the need to encourage greater diversification of our banking and financial system. Thus, it is essential that we continue to move ahead on interstate banking so that banks will be able to diversify their loan portfolios and deposit bases, thereby making themselves less vulnerable to regional economic difficulties.

In direct response to Senator Riegle's question, let me say that the Board has presently two pending powers matters. First, the real estate proposal and, second, the proposal to allow the acquisition of healthy thrift companies. Chairman Greenspan has advised Congress that the Board has no present plans to act on real estate or thrift powers, but we will review the situation from time to time and we will keep Congress informed of any proposed actions.

In conclusion, reviewing last year's events and the aggregate data on bank performance one could easily conclude that banking is not a good business to be in these days. However, that conclusion would be incorrect. To be sure, banking is no longer a highly protected and sheltered industry. Competition and deregulation have altered the dynamics of the industry and have created an environment in which now there are clear winners and losers and we are beginning to see the improvement in the asset quality of domestic loan portfolios of banking institutions outside the Southwest. While long overdue, this improvement should translate into better earnings performance as well.

Yet, despite the positive signs, much work remains to be done by bank managers and supervisors alike before we can fairly say that the problems that beset many of our banking organizations are behind us.

Thank you, Mr. Chairman.

[The complete prepared statement of Mr. Heller follows:]

Maintain Independence

The first step both the board and individual directors should take is to establish and maintain the board's independence. Effective corporate governance requires a high level of cooperation between an institution's board and its management. Nevertheless, a director's duty to oversee the conduct of the institution's business necessitates that each director exercise independent judgment in evaluating management's actions and competence. Critical evaluation of issues before the board is essential. Directors who routinely approve management decisions without exercising their own informed judgment are not serving their institutions, their stockholders, or their communities adequately.

Keep Informed

Directors must keep themselves informed of the activities and condition of their institution and of the environment in which it operates. They should attend board and assigned committee meetings regularly, and should be careful to review closely all meeting materials, auditor's findings and recommendations, and supervisory communications. Directors also should stay abreast of general industry trends and any statutory and regulatory developments pertinent to their institution. Directors should work with management to develop a program to keep members informed. Periodic briefings by management, counsel, auditors or other consultants might be helpful, and more formal director education seminars should be considered.

The pace of change in the nature of financial institutions today makes it particularly important that directors commit adequate time in order to be informed participants in the affairs of their institution.

Ensure Qualified Management

The board of directors is responsible for ensuring that day-to-day operations of the institution are in the hands of qualified management. If the board becomes dissatisfied with the performance of the chief executive officer or senior management, it should address the matter directly. If hiring a new chief executive officer is necessary, the board should act quickly to find a qualified replacement. Ability, integrity, and experience are the most important qualifications for a chief executive officer.

Supervise Management

Supervision is the broadest of the board's duties and the most difficult to describe, as its scope varies according to the circumstances of each case. Consequently, the following suggestions should be viewed as general.

Establish Policies. The board of directors should ensure that all significant activities are covered by clearly communicated written policies which can be readily understood by all employees. All policies should be monitored to ensure that they conform with changes in laws and regulations, economic conditions, and the institution's circumstances. Specific policies should cover at a *minimum*:

- loans, including internal loan review procedures
- investments
- asset-liability/funds management
- profit planning and budget
- capital planning
- internal controls
- compliance activities
- audit program
- conflicts of interest
- code of ethics

These policies should be formulated to further the institution's business plan in a manner consistent with safe and sound practices. They should contain procedures, including a system of internal controls, designed to foster sound practices, to comply with laws and regulations, and to protect the institution against external crimes and internal fraud and abuse.

Monitor implementation. The board's policies should establish mechanisms for providing the board the information needed to monitor the institution's operations. In most cases, these mechanisms will include management reports to the board. These reports should be carefully framed to present information in a form meaningful to the board. The appropriate level of detail and frequency of individual reports will vary with the circumstances of each institution. Reports generally will include information such as the following:

- the income and expenses of the institution
- capital outlays and adequacy
- loans and investments made
- past due and negotiated loans and investments
- problem loans, their present status and workout programs
- allowance for possible loan loss
- concentrations of credit
- losses and recoveries on sales, collection, or other dispositions of assets
- funding activities and the management of interest rate risk
- performance in all of the above areas compared to *past* performance as well as to *peer groups'* performance
- all insider transactions that benefit, *directly or indirectly*, controlling shareholders, directors, officers, employees, or their related interests
- activities undertaken to ensure compliance with applicable laws (including among others, lending limits, consumer requirements, and the Bank Secrecy Act) and any significant compliance problems
- any extraordinary development likely to impact the integrity, safety, or profitability of the institution

Reports should be provided far enough in advance of board meetings to allow for meaningful review. Management should be asked to respond to any questions raised by the reports.

Experience has shown that certain aspects of lending are responsible for a great number of the problems experienced by troubled institutions. The importance of policies and reports that reflect on loan documentation, performance, and review cannot be overstated.

Provide for independent reviews. The board also should establish a mechanism for independent third party review and testing of compliance with board policies and procedures, applicable laws and regulations, and accuracy of information provided by management. This might be accomplished by an internal auditor reporting directly to the board, or by an examining committee of the board itself. In addition, a comprehensive annual audit by a CPA is desirable. It is highly recommended that such an audit include a review of asset quality. The board should review the auditors' findings with management and should monitor management's efforts to resolve any identified problems.

In order to discharge its general oversight responsibilities, the board or its audit committee should have direct responsibility for hiring, firing, and evaluating the institution's auditors, and should have access to the institution's regular corporate counsel and staff as required. In some situations, outside directors may wish to consider employing independent counsel, accountants or other experts, at the institution's expense, to advise them on special problems arising in the exercise of their oversight function. Such situations might include the need to develop appropriate responses to problems in important areas of the institution's performance or operations.

Heed supervisory reports. Board members should personally review any reports of examination or other supervisory activity, and any other correspondence from the institution's supervisors. Any findings and recommendations should be reviewed carefully. Progress in addressing identified problems should be tracked. Directors should discuss issues of concern with the examiners.

Avoid Preferential Transactions

Avoid all preferential transactions involving insiders or their related interests. Financial transactions with insiders must be beyond reproach. They must be in full compliance with laws and regulations concerning such transactions, and be judged according to the same objective criteria used in transactions with ordinary customers. The basis for such decisions must be fully documented. Directors and officers who permit preferential treatment of insiders breach their responsibilities, can expose themselves to serious civil and criminal liability, and may expose their institution to a greater than ordinary risk of loss.

Copies of this publication, ***Pocket Guide for Directors*** *– Guidelines for Financial Institution Directors*, are available from the Office of Corporate Communications, Federal Deposit Insurance Corporation, 550 Seventeenth Street, NW, Washington, D.C. 20429, or through the Board of Governors of the Federal Reserve System, the Federal Home Loan Bank Board and the Office of the Comptroller of the Currency.

A more detailed discussion of a director's role and responsibilities is available in the Office of the Comptroller of the Currency's new book, ***The Director's Book*** *– The Role of a National Bank Director*, which is available from the Communications Division, Office of the Comptroller of the Currency, Washington, D.C. 20219

INEQUITIES IN THE DEPOSIT INSURANCE SYSTEM

There always has been some degree of inequity in the deposit insurance treatment of large and small failing banks. Specifically, there has been a tendency to handle large failing banks in a manner that protects uninsured depositors and other general creditors from loss while smaller failing banks are more frequently subject to a statutory payoff, thus uninsured creditors are exposed to loss.

In recent years, the FDIC has occasionally placed a de facto "guarantee" on the liabilities of certain institutions (more accurately, the FDIC has made a commitment to handle the bank(s) in a manner that would not result in losses to general creditors). This action has been taken in situations where there is a perceived threat to the stability of the banking system. This "guarantee" has been limited to three cases: Continental Illinois in 1984; First City and First Republic in 1988.

The FDIC is well aware of the competitive distortions that result from taking an action that permits an institution to issue liabilities "guaranteed" by the U.S. Government. Thus, such action has not been taken lightly.

A variety of suggestions have been made that are designed to ameliorate the distortions associated with an outright guarantee. While each of the suggestions is intended to achieve equity, each also would have some negative impacts. The following is a brief summary of the pros and cons of each proposal.

- Depositor Discipline. The ability of the FDIC to provide more protection than the statutory limit would be restricted. This suggestion would remove inequity between large and small banks. However, it could lead to an unacceptable level of instability in the banking system.

- Raise Insurance Premiums for Large Banks.. Premiums would be based on total liabilities that fall in the same creditor class as deposits. This suggestion would bring the insurance cost for large institutions more in line with de facto coverage, thus reducing inequities. However, these added costs may overly restrict large banks' ability to compete in global markets. Larger banks may respond by shifting business to noninsured subsidiaries, thereby reducing premium income.

- Provide 100 Percent Deposit Insurance To All Banks. This would be the most straightforward way of providing all depositors with the same treatment regardless of the size of their bank. The cost to the FDIC fund would be negligible (at least in the short run) because most depositors are already protected. Furthermore, it would be easier to handle failures because there would be no need to compute insured deposits on payoff; an entire deposit base could be transferred easily, leaving behind creditors and contingent claims.

  A full insurance approach, however, would completely eliminate depositor discipline and might raise longer-term insurance costs. It also would remove incentives for spreading deposits to smaller banks to maximize insurance coverage.

- Modified 100 Percent Deposit Insurance Coverage. This suggestion would not extend 100% coverage to certain deposits such as negotiable time deposits. Only transaction accounts and consumer and local business-type time deposits would get full coverage.

  Such an approach would reduce big bank/small bank inequity without completely eliminating depositor discipline. It does reduce depositor discipline, and it doesn't eliminate big bank/small bank inequities. Therefore, this suggestion represents only a partial solution.

- Limit Business Activities of Banks Operating Under 100 Percent Guarantee. This approach would require that rates on deposits be kept below market rates; business solicitation (letters of credit, etc.) would be restricted to existing customer base.

  If used, it would minimize damage to bank competitors. However, some customers might still be attracted by the insurance guarantee without added solicitation. Moreover, this suggestion does not resolve the big bank/small bank equity issue.

- Restrict the Full Insurance Guarantee to Existing Deposit Accounts. This suggestion would not permit a bank to use an insurance "guarantee" to attract new business, therefore minimizing damage to bank competitors. However, it would limit the ability of a bank to replace outflows with new deposits. It also would create massive recordkeeping problems for the bank, and for the FDIC if the bank is ultimately paid off. Furthermore, it may lead to market confusion over what is, and what is not, insured. It does not resolve the small bank/large bank equity issue.

- Extend Guarantee to Other Banks in State. Providing a full insurance guarantee to all banks operating in the same state would preserve intrastate equity. However, inequities would remain with respect to out-of-state competitors. Furthermore, banks within the state operating with 100% insurance might raise new supervisory issues.

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Statement by

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Member, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

May 25, 1988

I welcome the opportunity to appear before this Committee today on behalf of the Federal Reserve Board to discuss the condition of our nation's banking system.

This morning, I will review the general conditions and trends affecting the health of our nation's banking organizations and then discuss some of the financial and supervisory issues raised in your letter of invitation. I will also describe the supervisory steps we have taken to improve conditions in the banking system. In response to the Committee's request, the federal banking agencies have provided a large volume of financial data to the Committee's staff. Limitations of time and space do not permit me to cover all of this information in detail.

Overview of Banking Conditions

Conditions in the banking system tend to mirror conditions in the economy. We are now in the longest economic recovery in postwar history, and one might reasonably expect the condition of the banking system and measures of its aggregate performance to reflect that strength. Unfortunately, these aggregates may be deceiving because certain regions and sectors of our economy have been beset by serious structural problems over the last several years. For example, the rise of the dollar in the early 1980s hurt industries and firms in the Northeast and Midwest that depended on exports. Moreover, weaknesses in the agricultural and energy sectors of our economy have spread distress in the Midwest and Southwest regions of the country.

The resulting problems for the banking system have been aggravated by restrictions on geographic expansion that have left a large segment of our banking industry vulnerable to local and regional economic problems. Thus, despite a generally strong economic recovery, many financial institutions are under severe financial stress.

Beyond these regional and sectoral developments, our banking system has been buffeted during the 1980s by general forces and specific events that have challenged bank managers and supervisors alike. The industry has had to cope with unusual volatility in interest rates, exchange rates, and commodity prices. Moreover, during this period, many developing countries have experienced significant financial and economic problems -- a situation that has adversely affected the earnings and asset quality of our larger institutions.

In addition, competition in banking and the more broadly defined financial services industry has intensified, both at home and abroad. The change brought on by deregulation, product innovation, and technological advances can only enhance long-run efficiency, but in the short-run it has raised the costs and increased the pressures faced by the banking industry.

On top of all of this, debt has mounted rapidly. Households, businesses, and governments have taken on heavier debt loads, and in the process, the relationship between the volume of outstanding debt and the equity and earnings of borrowers to support that debt have worsened. In short, this development has contributed to weaknesses in asset quality and a corresponding increase in the risks faced by banks and other providers of credit.

In light of these developments, it is not surprising that major segments of the banking industry today confront significant problems and challenges. Indeed, 1987 was an extremely difficult year for our banking system as total nonperforming loans increased, earnings declined, and the number of problem banks and bank failures reached record highs.

While many banks continue to face serious problems, the vast majority of all institutions have been able to cope with the challenges confronting them and they are resolving their difficulties. Our economy continues to grow, and conditions in the agricultural sector have begun to improve. Growth of exports has helped strengthen our industrial and manufacturing sectors. Against this background, many institutions have seen their earnings and their asset quality improve. In sum, the banking system is basically sound, but it will continue to face many challenges in the coming years.

Regional and Sectoral Problems

Depressed conditions in the energy sector have resulted in enormous losses on energy loans and more recently on commercial real estate loans for banking organizations in the Southwest. Of the total of 2,870 banks in this region, 1,017 lost money last year; these losses meant a negative return on assets of 0.64 percent for banks in the Southwest. Nonperforming assets of the region's banks rose significantly. Real estate loans accounted for much of the increase, and, according to the available evidence, property values in many Texas markets have not yet bottomed out. The heavy losses of the last several years have eroded the capital of banking organizations in the region, forcing many to recapitalize or to restructure, and in some cases to seek supervisory assistance. While progress is being made, we still have a way to go before the problems in the Southwest will be behind us.

Similarly, banks operating in the farm belt or serving agricultural communities have shared the distress in the agricultural sector. Fortunately, 1987 saw a turn for the better. Farm commodity prices rose, production expanded, and farm income increased. Farmland values, which had been declining for a number of years, also began to rise. Last year, the aggregate net worth of farmers increased for the first time since 1980.

Improvements in the farm sector helped to relieve the pressures on banks serving farm communities. The profitability of farm banks, as measured by return on assets, rose on average from 0.34 percent in 1986 to 0.65 percent in 1987. The ratio of nonperforming assets to total assets also declined from a high of 2.2 percent in 1985 to 1.4 percent by the end of 1987. Finally, the capital ratios of farm banks also improved in 1987.

Another area of concern, which appears to cut across regional boundaries, is commercial real estate lending. In many locations, the supply of new office buildings has far outstripped

the demand. Vacancy rates in many downtown and suburban office building markets are currently at or near record highs. As a consequence, some financial institutions that lent heavily during the construction boom are now experiencing credit difficulties. While the most serious problems appear to be concentrated in the Southwest markets that also suffer from problems in the energy sector, they are by no means confined to that region. Problems have begun to surface in the Southeast and elsewhere.

An area that bears watching in the future is leveraged buyout financing. While LBO financing offers the potential for attractive returns, it also poses high risks because it involves lending on a highly leveraged basis. As with any other type of lending, success depends on the quality of the credit analysis and on the manner in which the transactions are structured and financed. At this juncture, special caution is in order because LBO financing is a fairly new activity for banks and has yet to be tested in an environment of high interest rates or economic recession.

The International Debt Situation

The international debt situation significantly affected income statements and balance sheets of many multinational and regional banking organizations. In this area circumstances change frequently and progress is interrupted all too often. Despite these setbacks, meaningful progress has been achieved. For example, leaders in a number of borrowing countries have recognized the need to restructure their economies by placing greater emphasis on the private sector; by reducing trade barriers, public sector deficits, and unnecessary government restrictions; and by improving their external trade accounts and economic growth. Moreover, the large amount of capital raised by U.S. banks in recent years has reduced the size of their exposure to developing countries in relation to their capital bases.

Last year Brazil suspended interest payments on its medium- and long-term foreign-currency obligations. In response to this development and to uncertainties about the status of loans to other developing countries, banking organizations began to recognize formally the increased risk in their credits to developing countries. Virtually all of the larger banking organizations took substantial loan loss provisions, and loans to Brazil and some other countries were placed in nonaccrual status. The result was that, at the larger banking organizations, earnings turned sharply negative, nonperforming asset ratios soared, and equity capital ratios declined.

Brazil's leaders have acknowledged that the moratorium did not serve their country's interests. Indeed, Brazil recently made some interest payments on these loans, and is normalizing relations with its creditors in a constructive manner. The resumption of interest payments by Brazil reinforced the view that interruptions of interest payments are not a solution to the international debt problem. This offers promise for the continued cooperation of the parties involved in the years ahead.

Recently, a number of options have been developed that can help banks manage their exposure to developing countries, as

well as help those countries reduce their outstanding debts. For example, banks have sold funds to companies seeking to invest in developing countries, engaged in debt-for-equity swaps for their own account, and exchanged part of their debt obligations for securities.

The Federal Reserve has also provided greater flexibility to U.S. banks by liberalizing regulations dealing with debt-for-equity swaps. Some regional banking organizations have significantly reduced their exposure by coupling increases in loan loss provisions last year with sales of developing country loans in the secondary market. A few smaller banks have exercised the option to withdraw from new money packages via so-called exit instruments -- for example, in connection with the recent Mexican exchange offer -- but such instruments have not yet gained wide acceptance.

Despite the progress that the borrowing countries themselves have made, and despite the options bankers have developed for managing their risk exposure, we have a long way to go before the LDC debt problem will be resolved. In the Board's view, the case-by-case approach put forward by Secretary Baker remains the best solution to these problems. It focuses on a revival of economic growth to enhance the debt-service capacity of the debtor countries and calls upon the commercial banks to sustain their lending while the countries regain access to international capital markets. In addition, the multilateral financial organizations are to provide their expertise and financial resources to help the countries to bring about external adjustment within a context of economic growth.

The Performance of the Banking Industry

Let me address now the performance of the banking industry in 1987. I will focus on the areas identified in the Committee's letter of invitation.

Asset Quality. As noted earlier, asset quality has been the greatest problem facing the industry. Last year, the ratio of nonperforming assets to total assets -- a key indicator of asset quality -- reached a postwar high. For all insured commercial banks, this ratio rose from 1.6 percent in 1986 to 2.1 percent at the end of 1987; for the 17 multinational bank holding companies, the ratio increased from 2.2 percent to 3.6 percent of total assets. The principal reasons for the increase were the placement of a large amount of LDC debt in nonaccrual status and the continuing energy- and real estate-related problems in the Southwest.

The asset quality picture has a positive side, however. If we set aside the effect of LDC nonaccruals and the problems in Texas, we find that domestic asset quality, as measured by the nonperforming asset ratio, improved last year. This improvement occurred despite the worsening of problems in the real estate sector. For example, after making these adjustments, the nonperforming asset ratio for the 17 multinational bank holding companies declined from 2.1 percent in 1986 to 1.8 percent last year. For banks under $1 billion in total assets, the ratio

declined to its lowest level in five years. Another indicator of asset quality, the ratio of net loan charge-offs to total loans, confirms this trend. The net loan loss ratio for all insured commercial banks decreased 6 basis points in 1987 to 0.93 percent of average loans. Significant declines occurred also at banks with assets under $1 billion.

While these trends permit cautious optimism in the outlook for asset quality, both nonperforming asset ratios and charge-off ratios remain high. This is troublesome when we consider that we are in the sixth year of an economic expansion. In the past, bank asset quality has shown improvement at earlier stages of the economic recovery. Obviously, any unforeseen shocks or economic reversals could have serious negative implications for the loan portfolios of some banking organizations.

Profitability. Not surprisingly, the high level of problem assets has eroded the profitability of the banking industry in recent years. In 1987, the average return on assets for all insured commercial banks declined almost 50 basis points to 0.12 percent, and the average return on equity dropped a precipitous 750 basis points to 2.02 percent.

These aggregate measures of industry profitability mask disparities in the performance of banks in different size groups and in different regions of the country. The special LDC provisions taken last year caused significant losses or declines in earnings at the large multinational and regional institutions. Indeed, the average return on assets for the 25 largest banks declined from 0.51 percent in 1986 to a negative 0.79 percent last year. And, as I have indicated, banking organizations in the Southwest continued to experience substantial losses. Yet despite the dismal earnings performance of the industry as a whole last year, many institutions remained profitable. Over half of all insured commercial banks had returns on assets of 0.81 percent or more. Many organizations that maintained well-balanced portfolios and avoided excessive exposure in certain problem areas reported strong earnings. In addition, outside of the Southwest, banks with assets of less than $1 billion generally reported improved returns on assets and equity, reversing several years of declining profitability.

Some of the very largest banking organizations have cushioned the impact of credit quality problems on profitability by changing the composition of their revenues. These banks have achieved a robust growth in noninterest income, reflecting their emphasis on fee-based services, such as investment banking, securities processing, and cash management. Nonrecurring transactions such as asset sales have also boosted the earnings of many larger organizations, and trading account income has become an important component of revenue.

First-quarter earnings reports reflect an improvement over last year's depressed levels. While data are not available for all banks, the average return on assets for state member banks rose to an annualized rate of 1.00 percent. The profits of the 17 multinational bank holding companies were also up significantly, although many still relied heavily on nonrecurring gains. In general, aggregate bank profits should recover in 1988 from last year's depressed level because of lower loan loss reserves, tax benefits, and cost control and restructuring programs implemented by many institutions.

Capital. Although capital has long been an issue in the banking industry, it took on greater significance in 1987 because of the heavy losses sustained by many of the largest organizations. In 1987, the average ratio of equity capital (excluding loan loss reserves) to total assets for the 25 largest commercial banks declined from 5.1 percent to 4.3 percent. This decline marks a reversal of six years of steady improvement for this group. The ratio of equity capital to total assets also declined significantly for banks in the Southwest. For the remainder of the industry, however, ratios of equity to assets generally improved in 1987.

The ratio of primary capital, which includes loan loss reserves, to total assets for all insured commercial banks increased 49 basis points to 7.8 percent at the end of 1987. Much of this increase was accounted for by the increase in loan loss reserves, a result of the special LDC provisions.

The recent decline in equity capital ratios at our larger institutions, stemming from the heavy losses related to the LDC situation, has stirred understandable concern. But, one of the principal functions of capital is precisely to absorb losses and cushion other financial adversities. In this connection, the capital guidelines program that the federal banking agencies initiated in 1981 to encourage banks to strengthen their capital positions has proved beneficial and timely, for it clearly has put banks in a better position to withstand the financial pressures and problems that have confronted our banking system over the last several years.

Liquidity. We believe that the levels and trends of liquidity within the banking system are generally satisfactory. At the same time, some financially troubled banking organizations have experienced liquidity difficulties. In general, such organizations can obtain the funds they need to continue operations but, to do so, they typically must pay premiums over market rates. For some time, this has been the case for banking and thrift organizations operating in Texas. Unfortunately, the high premiums that weak institutions often pay compel healthy banks to raise their offering rates for deposits and other funds in order to compete with the weak institutions.

Let me stress, however, that liquidity has not been a problem in the system generally. The events surrounding the stock market collapse of last October underscored this point. During the week of October 19th, concern arose that liquidity in the banking system would dry up as a result of doubts about the creditworthiness of major market participants. Nevertheless, banks were responsive to the legitimate funding needs of their customers, and no large-scale liquidity problems developed. As you know, the Federal Reserve stood ready to provide the liquidity needed to prevent isolated problems from spreading through the financial system.

Problem and Failed Institutions

The problems and conditions I have described have resulted in a steady increase in the number of problem and failed banks since 1981. The number of institutions on the list of FDIC-insured problem banks and thrift institutions rose from 223 in 1981 to 1,575 at the end of 1987. Of that total, over 95 percent had assets of less than $300 million; and 88 percent were located where problems in the farm, energy, and real estate sectors have been most acute. In particular, the number of FDIC-insured problem institutions in the Southwest -- Texas, Oklahoma, Louisiana, Arkansas, and New Mexico -- increased significantly last year, more than offsetting an encouraging decline in the number of problem institutions in the Eastern and Central regions of the country.

Last year, 184 FDIC-insured institutions were closed and another 19 were granted open bank assistance, compared with 138 and 7, respectively, in 1986. In 1981, these figures stood at 7 closings and 3 assistance transactions. The results for last year show that 90 percent of failures and open bank assistance transactions occurred west of the Mississippi. While bank closings and open bank assistance transactions declined somewhat in the Midwest last year, the situation in the West and Southwest continued to deteriorate. In these regions, the number of closings and open bank assistance transactions increased from 84 in 1986 to 145 last year. Sixty percent of all bank failures in 1987 were located in only four states: Texas, Oklahoma, Louisiana, and Colorado. With respect to the commercial banks under the supervision of the Federal Reserve, 10 state member banks failed in 1987 versus 11 the previous year. So far this year the number of state member bank closings is larger than it was at the same point in 1986.

As these figures suggest, the problems have centered in states that historically have strictly limited branching and other forms of geographic expansion. In addition, federal restrictions have prevented institutions from expanding across state lines. These limits have severely hampered our financial institutions in diversifying their portfolios and, therefore, have left them more vulnerable to sectoral and regional economic strains.

We will all agree that the number of bank failures is too high, and much work needs to be done to address the conditions I have described. While we have begun to see some improvement in domestic asset quality at many institutions outside the Southwest, the continuing high level of problem assets suggests that we are unlikely to see any decline in the number of bank failures this year.

Supervisory and Regulatory Initiatives

The Federal Reserve has taken steps over the last several years to strengthen its ability to identify and address problems in the banking system. These steps include more frequent on-site examinations of large and problem banking organizations, more frequent meetings between Reserve Bank officials and bank directors, improvements in techniques for

communicating with management and directors, the strengthening of supervisory enforcement programs for addressing mismanagement and unsound banking practices, the expansion of cooperative examination arrangements with state banking departments, and enhancement of examiner training programs. We have also tightened our standards for reviewing and approving applications of new banks to become members of the Federal Reserve System.

While structural and regional economic problems are major factors in explaining the high level of bank failures, we find that mismanagement, insider abuse, and criminal misconduct have played a role in many bank closings. To address these problems, the banking agencies have worked with the law enforcement agencies to improve our ability to detect improper banking practices and to identify, refer, investigate, and prosecute instances of white collar crime involving commercial banks. This program has resulted in more enforcement actions and criminal referrals. In the future, the banking and law enforcement agencies must continue to work diligently to address these problems.

The Federal Reserve has supported these efforts by devoting additional resources to the supervision function and by augmenting its force of supervisory personnel and field examiners. However, the problems we have faced have worsened in both number and kind. We believe the steps we have taken will prove helpful, but we will not be satisfied until the number of problem banks and bank failures is controlled. While it is not expected, any further deterioration in the banking industry could

The CHAIRMAN. Thank you, Mr. Heller.

In view of the fact that we only have four members of the committee present this morning, the time of questioning will be 10 minutes.

Comptroller Clarke, you and the other regulators have made similar statements. You cited as a problem the large loans many major banks have made to lesser developed countries. The GAO in its recently released report on the supervision of overseas lending concluded that the OCC, the FDIC and the Federal Reserve have required inadequate reserves for the country risks contained in U.S. banks' foreign loans.

Let me just give a quotation—and I want your comment on it—from the GAO report. Here's what they said:

> Although the OCC, FDIC and Federal Reserve required only $2.3 billion in reserves for foreign loans, the banks themselves have reserved about $21.1 billion. The GAO believes that even $21.1 billion is inadequate. Much LDC debt sells at large discounts on the secondary market because investors believe it to be particularly risky. In October 1987, secondary market prices imply that at least $49 billion in reserves is needed.

Now is the GAO right? If not, why not? And if so, how do you justify the fact that you and the other regulators required only $2.3 billion in reserves? That seems to be pitifully inadequate.

Mr. CLARKE. Mr. Chairman, I would disagree with the GAO findings, as did our Office when we were asked to comment on them before the report was released.

When you talk about reserves that are required by us or by the Fed or the FDIC, they result from a process set up by the Congress in the form of a committee referred to as ICERC which meets three times a year and evaluates all foreign country debt. For debt that has been in arrears for a specified period of time or has certain other attributes, that committee can mandate reserves, and that's the $2.2 billion that GAO is talking about.

Otherwise, we don't set reserves for banks. We don't require bank reserves for LDC debt generally or any other kind of debt—real estate loans, oil and gas loans——

The CHAIRMAN. Well, isn't it logical that you should? After all, the banks themselves, as I pointed out, have $21.3 billion and you regulators have only required about 10 percent of that. It sounds like very permissive or—depending on how you want to consider it—weak regulation.

Mr. CLARKE. It all depends on how you view a loan loss reserve and how you view the ultimate collectibility of the loans that you're reserving against. A loan loss reserve is only an estimate of what you think your loss on a portfolio is going to be. If you think your loss is going to be 100 percent of that portfolio, then a 25-percent reserve is probably inadequate and a 50-percent reserve is probably inadequate. On the other hand, if you believe, as I do, that we are dealing with a long-term problem that requires a long-term solution, very little, if any, of that debt may ultimately result in a loss to the bank except to the extent that banks engage in swaps or trades or otherwise voluntarily take losses on it. But in terms of debt that is to be repaid at some point, you may very well not have very much of a loss.

I think your view of that debt and the ultimate collectibility of that debt has to shape the way you build your reserves. That's exactly what you see happening with the banks. You have some banks that made the decision that they no longer want to have any LDC exposure and have sold all of their debt and taken some big losses on it. You have other institutions that have decided to be long-term players in this business and believe that their reserve is adequate. And I don't think it is appropriate for bank regulators to try to divine what is the correct precise amount of reserves. That's why we don't do it.

The **CHAIRMAN**. Well, I just have the feeling that if the regulators aren't reasonably strict—as I point out, here you have a situation where the banks themselves have reserves ten times—almost ten times what you feel is necessary. Are they doing this for some other reason that I'm too naive or too stupid to perceive?

Mr. **CLARKE**. No, sir. I think they are making their own decisions about what they think their reserves should be in their particular institutions, which I think is appropriate.

The **CHAIRMAN**. And you think their judgment is much too conservative?

Mr. **CLARKE**. We have banks that have much more than minimum prescribed capital levels, but that doesn't mean we should raise our minimum levels to meet the levels that some banks have chosen to maintain.

The **CHAIRMAN**. Mr. Seidman, in August 1987, Congress placed the full faith and credit of the United States behind the Federal Deposit Insurance agencies. The second insolvency of FSLIC raises the possibility that fulfilling that guarantee could be an expensive proposition in the S&L industry. Professor Greenbaum, of Northwest University, testified last week in this committee that there are three oxen that are candidates for goring—healthy S&L's, the banks, and Mr. and Mrs. America. What is your estimate of the cost of an S&L cleanup?

COST OF S&L CLEANUP

Mr. **SEIDMAN**. We are studying that right now, Mr. Chairman, and as you know, the estimates vary from the Bank Board's about $20 billion to others who have said up to $60 billion. We are not in a position at this point to give a definitive answer, but I would say that based on our experience in real estate in some of the areas involved we would believe that the estimate would be somewhere between those.

The **CHAIRMAN**. Between $20 billion and $60 billion?

Mr. **SEIDMAN**. Could I say, Mr. Chairman, just on one other——

The **CHAIRMAN**. That's a good answer. It's not very precise, but it's a safe answer.

Mr. **SEIDMAN**. Well, sir, it's an answer—I believe it takes a lot of study and I would like to see this committee delve into that and find out how all these people calculated it, find out how the Bank Board calculates their $20 billion, so we would have a basis on which we could render an opinion. I think it's a vitally important topic and it's one where really we need to get all the information on it.

The CHAIRMAN. Well, that's why I'm asking you because you're certainly in a very strong position outside the savings and loan industry to give us very expert opinion. So anything further you would like to add for the record we would appreciate.

Mr. SEIDMAN. We will do that.

The CHAIRMAN. How should we cover that cost?

Mr. SEIDMAN. Well, I guess I would start by saying that the most unfair way to cover it would be to take the banks' hard-earned savings in their own insurance fund and use it to cover the cost of a competitive industry.

It seems to me that the key questions are two. One, can the industry pay for it itself? If it can, it ought to. If it can't, I believe it will have to be paid for by the people of the United States. And if that's so, what can be done to ensure that that kind of cost is not incurred again?

The CHAIRMAN. In view of the fact that we now have six members, I think we'll go to 5 minutes. Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

Mr. Seidman, what is your view of the potential rush for thrifts to join the FDIC? Do you think that the moratorium on departures ought to be extended?

Mr. SEIDMAN. Well, first, the FDIC takes the view that under the law we are required to admit any institution which qualifies as a bank under our definition which has appropriate standards. So we would in the normal course admit institutions that qualify.

With respect to whether the moratorium should be continued, I think that is a public policy question of how the FSLIC situation is going to be handled on a long-term basis.

If the Congress is moving to resolve that, then perhaps the moratorium can be increased. If it's not, perhaps the system ought to be allowed to work under present rules.

Senator GARN. You have submitted draft legislation to help the FDIC deal more effectively with problems in banks that are part of multibank holding companies. It's my understanding that this type of proposal would have saved the insurance fund a significant amount of money in some of the recent assisted transactions in Texas. Mr. Clarke and Mr. Heller, rather than taking all of your time, and rather than trying to outline it for us today, I would appreciate it if you would respond in writing to the committee regarding what you think of this proposed legislation.

Mr. Clarke, in your statement you express continued support for the Baker initiative on LDC debt. At the same time, you report the largest 29 national banks, particularly because of their LDC exposure, increased their provisions for loan losses from $6 billion in 1986 to $16 billion last year.

BAKER INITIATIVE

The Baker initiative calls for increased bank lending to the LDC's. My question is, with these large increases in loan loss reserves, how can the Baker initiative work? Where does the money come from—an extra $10 billion for loan loss reserves? Where do they find the money for additional lending?

[Response to questions by Senator Garn to Mr. Clarke can be found in the response to written questions by Mr. Clarke.]

Mr. CLARKE. Senator, if you recall, when the Baker initiative was first announced in 1985, it involved a joint effort among multilateral lending institutions, banks and others to provide the funding. Banks were only one part of that program.

Notwithstanding the fact that they have a reserve, if banks believe that it is in their long-term best interest to extend additional credit, accompanied by the right kind of terms and conditions, such as commitments for domestic reforms and the like, it seems to me they could very easily lend additional funds.

Senator GARN. Mr. Seidman or Mr. Clarke, as you well know, the Senate recently passed the Proxmire Financial Modernization Act. Title V of this act contains provisions enhancing the enforcement powers of bank regulatory agencies. Since we passed that bill—and in the bill that's before the House Banking Committee there are similar provisions as well—there have been some people in the banking industry who have expressed concerns about certain aspects of this title.

Would you be willing to consider possible changes in title V prior to a conference?

Mr. SEIDMAN. We certainly would, Senator. We're working with the ABA right now. We are showing them cases that were background for our recommending these changes and we believe we'll be able to come to a reasonable compromise with them on some of the areas.

Senator GARN. If we can ever get the House of Representatives to act on the bill—with one exception since 1975, when I arrived here, they have an unbroken record of doing nothing. I always thought the House was supposed to be the progressive body, up every 2 years, responsible to the people and all of that, but they simply don't seem to want to do very much.

Mr. CLARKE. Senator Garn, may I comment on that for a moment?

Senator GARN. Certainly.

Mr. CLARKE. We, like the FDIC, are certainly willing to listen to any constructive suggestions for change in the enforcement provisions that we recommended and that are contained in that bill, but it's our view, based on talking to a number of industry representatives, that there's been a lot of misunderstanding about what those enforcement provisions are intended to accomplish. It's my hope that by explaining in more detail exactly what we had in mind that we will have everybody feeling more comfortable about the provisions. They are not intended to be onerous.

Senator GARN. Mr. Heller, you note that in 1987 the average return on equity dropped 750 basis points to 2.02 percent. What's your forecast for 1988? Do you continue to see those margins shrinking, those trends continuing?

Mr. HELLER. Well, we don't forecast bank earnings, but the first quarter results have certainly been encouraging in that they point toward upward movement in those important ratios, so that the banking industry will be able to earn some of the capital that will be required to help boost the capital ratios in the years ahead.

Senator GARN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn.

Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

Let me ask you first, Mr. Clarke, you heard Mr. Heller indicate that the Fed has had two areas of possible regulatory action to consider with respect to additional bank powers or activities, and as I understood the answer, you had no plans to move unilaterally in the foreseeable future and let us know if that should change.

What plans, if any, do you have in the Comptroller's Office along those lines?

Mr. CLARKE. Senator, as you know, there are two different paths for regulatory action. One is through a rulemaking initiative, which involves public comment and the normal administrative process. The other way is in response to requests for interpretation of laws and regulations that are submitted to us and are specific to a particular bank or a particular transaction.

On the initiative front, we do not have anything pending. You may be thinking about what was reported—unfortunately, erroneously—in the press recently. There's a letter which you may have seen this morning in the *American Banker* attempting to clarify that erroneous information. With the chairman's permission, I would like to have that letter inserted in the record. I think there's a lot of misunderstanding about what that alleged initiative would do.

Senator RIEGLE. Why don't you just take a minute and elaborate on that as long as that's in the news and topical?

Mr. CLARKE. It has to do with collective funds that have been authorized for bank trust departments for years and that are available only to customers for which the bank trust department acts as a fiduciary.

We have considered for a number of years—this is not something we just thought up, this is something that has been talked about first is 1982 in an advanced notice of proposed rulemaking—allowing banks to advertise more widely the fact that they offer this service for their fiduciary accounts and allowing them to charge for those services fees that are more directly related to the administration of the collective investment funds rather than a trust administration fee, which, of course, they charge now.

It's simply a matter of allowing greater flexibility in advertising. It's important to remember, however, that we are a long way away from having a proposed rule to the point that we would even put it out for comment, let alone have it adopted as a final regulation.

Senator RIEGLE. And with respect to interpretative issues that are brought to you, is there anything cooking there that we should know about?

Mr. CLARKE. Not any that I can recall. I think we have a responsibility to recognize the concern that Members of Congress have about regulatory interpretations in these areas. I want to assure you that we don't think up these ideas; only respond when somebody comes to us with a request. I do feel, however, that we have an obligation when presented with a request for interpretation to act in a timely manner and to try to bring our best judgment to bear on what our laws and regulations permit.

Senator RIEGLE. Well, as you well know, in the banking bill that's been referred to that has passed the Senate overwhelmingly, one aspect of that was to basically move against an initiative of the Comptroller's Office and to shut it down because we felt—and I think it's fair to say—in the aggregate that that took the law or took the practice beyond what the view of the Congress would be was appropriate.

I think we're at a point right now where it's very important that we try to get our signals straight back and forth if we can and I hope we can and I think we can. I think the committee here has reached a judgment under the leadership of Senator Proxmire to go ahead and move in these areas on a broad scale. We've done so. I think we've produced a good bill. I'm hopeful that the House will act on it.

If for any reason they should not, I can tell you this, as the person who is a possible successor to Senator Proxmire, which is an awesome act to follow by any measure, that we'll pick that right up again and go with it at the beginning of next year because I hope that's not what we find because I hope we can act this year, but I think it's also fair to say that I think we're going to have a real problem if we find that the regulatory bodies decide that they're going to do the job that's really the Congress' job to do and I don't want to see us in that kind of a head-on collision if we can avoid it because I don't think it helps us and I don't think it gets us to an answer as rapidly as we'll get there in a more orderly way if we do it at this end.

So as far as I know there's nothing in that area that relates to your jurisdiction, Chairman Seidman.

Mr. SEIDMAN. That's correct, Senator. We don't create powers.

Senator RIEGLE. I'll have some more things in the next round. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Gramm.

Senator GRAMM. Well, Mr. Chairman, let me first say that I welcome our three witnesses today. I would have to say that I feel very strongly that we're blessed by having a Comptroller of the Currency and a head of the FDIC that are people who understand the problem and that are addressing it. And given that I represent a part of the country that finds itself a victim of these problems, I want personally to thank both of you for your leadership and your decisiveness in dealing with this problem.

As I see it, we have two major problems, and I'd like to focus on those. The first, obviously, is the regional recession in the Southwestern part of the country. I think Mr. Clarke is correct when he points out that all of our economic data indicate that at least Texas, which is really the important part of that region, bottomed out economically in the last quarter of last year and is beginning to sustain an economic recovery. If we can keep the national recovery going, I don't think there's any doubt about the fact that 1988 will be a better year economically in Texas than 1987 was.

I'd like to get an assessment from all three of you as to how you see our banking problems in the Southwest. Do you think that we have turned the corner? How do you feel we are in terms of the overall problem? Have we dealt with most of it, or is the majority of it still in front of us? Why don't I just start with you, Bob?

Mr. CLARKE. Senator Gramm, as I indicated in my written statement, we unfortunately do not anticipate the number of national bank failures in Texas during 1988 to be materially less than in 1987, even though so far this year there have been fewer failures than at the same time last year.

One of the problems is that the recovery in the economy benefits the banks later rather than earlier; it helps the business climate and helps the individual borrower first and that then has an effect on the banks. The huge oversupply of real estate gets eliminated only by several years of absorption of that real estate, and it's only then that you get the values back to more normal levels and that the banks that are holding large portfolios of that real estate get the benefit.

Senator GRAMM. Were you reflecting that in your audits, with regard to the value you attribute to this real estate, recognizing that if real estate in Houston is not a good long-term investment then there is no future for America?

Mr. CLARKE. We have given the examiners discretion to go into markets where there are what we believe to be unrealistically low real estate values and evaluate projects on a project-by-project basis and make judgments about what they think a more normal value would be over a 5 to 7 year period. There are some properties that 15 years from now may not have recovered because they're just not quality properties, but there are others that clearly will benefit sooner rather later in a real estate recovery. The examiners are given the discretion to make those judgments.

Senator GRAMM. Mr. Seidman.

Mr. SEIDMAN. Senator Gramm, our view is that your State this year as far as banking is concerned will have the worst year since the Great Depression. We estimate, and your commissioner estimates, that there may be 70 bank failures, including the First Republic transaction. So 1988 is going to be a record bad year.

We believe that 1989 looks better for two reasons. One, by the end of 1988 we believe that practically every major bank—that is, the large banks in the top ten—will have had its problems resolved in one way or another. And that is a very large percentage—over 50 percent of the total deposits in the State. The smaller banks are showing some recovery in the first quarter of 1988. I think they are reflecting the small upswing in the economy and we would expect smaller banks to be doing somewhat better in 1989.

Senator GRAMM. Mr. Heller.

Mr. HELLER. I agree with everything that Mr. Clarke and Mr. Seidman said. Let me add one more thought, though, and that is of long-term strategic importance. The Texas Legislature made it possible to engage in full interstate banking in Texas. I think that lays the basic groundwork for a healthier banking system not only in Texas, but also in the other States that will be participating in these interstate banking arrangements because that will give opportunity for greater diversification and therefore greater stability to the banking system.

Senator GRAMM. My time is up.

The CHAIRMAN. Senator Shelby.

strain our resources and require more funds for the supervision and regulation function, as well as the expansion of our cadre of supervisors and field examiners.

Capital Adequacy. The Federal Reserve consistently stresses the role of capital in promoting the safety and soundness of our banking and financial system. Organizations experiencing financial problems, including weaknesses in earnings and deficiencies in asset quality, have been required to develop and implement plans to broaden their capital bases.

Mergers and Acquisitions. Capital adequacy is especially important in evaluating the proposals of bank holding companies to expand. The Board has long believed that banking organizations undertaking marked expansion or large acquisitions should maintain strong capital positions, well above minimum supervisory levels. Thus the Board requires organizations making major acquisitions to support these plans with adequate capital, and it has discouraged merger transactions that weaken the capital position of the combined entity. In addition, in acting on merger applications, the Board has discouraged the use of accounting techniques or financial strategies intended to justify the payout or distribution of capital funds to shareholders when these resources may be needed to support the financial base of the merged organization.

Dividend Policy. In addition, we have discouraged excessive or unwarranted increases in dividends by banking organizations whose capital positions need strengthening. Indeed, the Federal Reserve has a fundamental policy that banking organizations under financial strain should consider reducing or even eliminating cash dividends in the absence of effective alternatives for raising capital.

Bank Holding Companies. In line with this emphasis on capital adequacy, the Board reiterated, in April of last year, its longstanding regulatory policy that bank holding companies should act as sources of strength to their subsidiary banks by standing ready to provide capital funds during times of financial stress.

Risk-Based Capital Proposal. The federal banking agencies have undertaken to strengthen supervisory standards for assessing capital adequacy through the development of an internationally accepted, risk-based capital framework.

This framework will help to achieve two important policy objectives of the Federal Reserve. First, it will encourage international banking organizations to strengthen their capital positions when necessary, taking into account off-balance-sheet exposure as well as conventional loans and investments. Second, the framework will serve to narrow competitive inequalities for international banking organizations stemming from differences in national supervisory requirements. This objective is particularly important in view of the internationalization of banking and financial markets.

The risk-based capital proposal establishes a common international framework for defining an organization's capital base that emphasizes core stockholders' equity. It also establishes procedures for factoring into the supervisory evaluation of capital needs, the riskiness of assets and off-balance-sheet exposures. In addition, the proposal sets out a schedule for achieving a minimum ratio of total capital to weighted risk assets: it is to be 7.25 percent by year-end 1990, of which at least 3.25 percentage points are to be in the form of common equity capital; and by the end of 1992, it is to be 8.0 percent, of which at least 4.0 percentage points must be common equity capital. The risk-based framework is still in the proposal stage, and the Board is currently reviewing comments and resolving the outstanding issues. We hope to implement the framework in conjunction with the other major industrial countries by year-end.

In general, the overwhelming majority of community and regional banking organizations will have little difficulty meeting the standards incorporated in the proposal. However, organizations whose capital positions are under pressures due to poor earnings, large loan losses, rapid growth, or excessive risk exposure may have to temper their growth, alter their asset mix, or raise additional capital to meet the minimum standards. As a rule, we believe banking organizations should endeavor to operate above these standards in order to maintain a critical buffer during periods of financial strain or adversity.

One of the major issues surrounding the requirements for risk-based capital is whether they will compromise the banking industry's ability to compete. The competitiveness of our banking system is, of course, a matter of concern to the Board. Clearly, it would be counterproductive to adopt a framework that would undermine the competitive position of our nation's banks. But, in the long-run, only a well-capitalized banking system can be a competitive and healthy banking system. Indeed, we have found that banking organizations with strong capital positions are the most effective competitors. Strong capital positions may actually give institutions a competitive advantage as customers, depositors, and investors seek stability and strength in their banks.

Expanded Powers

Although we believe that all these efforts will strengthen our banking institutions and make them more resistant to financial pressures, there are, of course, limits on what regulators can do unilaterally to deal effectively with the problems confronting our banking system. Congress has a key role to play in establishing an appropriate legal framework. The Board strongly supports Senator Proxmire's financial modernization bill, which would broaden the range of securities activities permissible for banking organizations by repealing the Glass-Steagall Act's separation of commercial and investment banking. This legislation will not only produce important public benefits, it will also enable banks to compete more effectively and broaden their sources of income. In addition, the serious problems experienced by banks in the Midwest and Southwest underscore the need to encourage greater diversification in our banking and financial system. Thus, it is essential that we continue to move ahead on interstate banking so that banks will be able to diversify their loan portfolios and deposit bases, thereby making themselves less vulnerable to regional economic difficulties.

Conclusion

In reviewing the year's events and the aggregate data on bank performance, one could easily conclude that banking is not a very good business to be in these days. However, that conclusion would be incorrect. To be sure, banking is no longer a highly protected and sheltered industry. Competition and deregulation have altered the dynamics of the industry and have created an environment in which now there are clear winners and losers. This new reality is evident behind the aggregate statistics, in the results for individual companies. We find that although many banking organizations reported very poor results in recent years, many others have turned in exceptionally strong performances. The large interstate banking organizations operating in the Southeast, New England, and the Middle Atlantic states are cases in point.

In recent years the problems in the banking sector have received a good deal of attention, as indeed they should. But, all too little attention has been given to the positive developments within the industry.

First of all, the ability of the overwhelming majority of institutions to absorb the severe shocks and stresses of recent years reflects their underlying strength and that of the banking system as a whole.

Second, bank managements have focused on the need to improve operations. They are rethinking their strategies and moving to restructure and streamline operations in order to meet the competitive challenges and enhance their profitability. They are focusing on improving credit analysis and on strengthening lending standards and risk-control systems. The capital positions of many of the larger money-center institutions are also being strengthened in order to meet the demands of the market and to comply with the proposed risk-based capital standards.

We are beginning to see some improvement in the asset quality of the domestic loan portfolios of banking institutions outside of the Southwest. While long overdue, this improvement should translate into better earnings performances. Earnings in the first quarter of this year appear to support this view. Yet, despite the positive signs, much work remains to be done by bank managers and supervisors alike before we can fairly say that the problems that beset many of our banking organizations are behind us.

Senator **Shelby**. Thank you, Mr. Chairman.

CONDITION OF FDIC

Gentlemen, what is the real condition of the FDIC considering the possibility of a downturn in the recession in late this year or early next year and will that have an impact on the FDIC's solvency?

Mr. **Seidman**. Clearly, Senator, the condition of the economy has an effect on the banking system and that has an effect on the FDIC. Our experience in the past has been that short, sharp recessions like we had, let's say in 1975-76, do not have a material effect on the banking system because they tend not to be long enough to really affect a large number of banks.

Clearly, if you have deep recessions of the type that Texas has had and it extends over a period, that will have a greater effect. But I would also point out to you that many parts of our country are experienced—the bankers are experienced with recessions. My home State of Michigan has been through them and I think they have perhaps been better prepared in their banks to deal with downturns.

Senator **Shelby**. Is the basic problem or central problem of the money center banks in the East—we'll speak of those for a minute—is it one of thin capitalization or lack of working capital considering their exposure to Third World loans and everything?

Mr. **Seidman**. That is clearly the major problem of the money center banks, the amount of loans that they have to less developed countries. We have done some work on that and I have a chart here that members of the committee may want to look at, which attempts to evaluate the ability of those countries to service debt. And without going all through it, it comes to the conclusion that those countries, on average, can handle about 70 percent of their current debt, which would mean reserving at the 30-percent level would be a reasonable level of reserves in that area.

Senator **Shelby**. Is it possible—well, I know it's possible—is it probable if we have a severe downturn in the economy in 1989, if we did, and we had some strange rumblings in the Third World loan area—is it probable that several of our money center banks might not survive in their present form?

Mr. **Seidman**. I don't think that that's a probability under any scenario that we——

Senator **Shelby**. Any scenario?

Mr. **Seidman**. Under any scenario we can foresee. I mean it's obviously clear that if we went into a world depression like we did in the 1930's that that would have a tremendous impact.

Senator **Shelby**. Several of them are well at risk, wouldn't you say?

Mr. **Seidman**. There is substantial risk, although because of the reserving that they've already done they are somewhat better than they have been in the past. I have also a chart here which shows what their capital would be if they reserved up to the 50-percent level. It shows that while all of them obviously would have reduced capital, all but one would have capital over 3 percent.

Senator **Shelby**. Could the banking business get down to what one writer says like market forces generally the haves and the have-nots, in other words, the ones that have capital are the ones that have nurtured it and the others that don't——

Mr. **Seidman**. That is certainly possible and I think that in those cases the weak ones will be taken over by the strong ones.

Senator **Shelby**. I want to get parochial for just a minute. Say from my State of Alabama to Virginia, the Southeast, what's the basic condition of the banks overall in those areas regionally?

Mr. **Seidman**. I would say overall the basic condition is good, prosperous and stable.

Senator **Shelby**. Compared to the oil patch and some of the money center banks?

Mr. **Seidman**. Compared basically to the situation west of the Mississippi.

Senator **Shelby**. Mr. Clarke, do you have any comments?

Mr. **Clarke**. I concur with that. The Southeastern region of the country, as well as the Northeast, are enjoying unprecedented prosperity, and that is certainly affecting the financial condition of the banks.

Senator **Shelby**. And minimal exposure to some bad loans maybe?

Mr. **Clarke**. As Governor Heller indicated earlier, the Southeast was one of the first regions to recognize the importance of diversification through regional interstate banking. It has a much more diversified banking environment and, therefore, much less concentration of exposure in particular areas. That's not to say there aren't some bad loans in various banks.

Senator **Shelby**. But relative to other areas, not bad loans?

Mr. **Clarke**. Certainly much more diversified.

Senator **Shelby**. Do you see a further concentration in the regional bank, especially the Southeast?

Mr. **Clarke**. In terms of acquisitions and mergers?

Senator **Shelby**. Yes.

Mr. **Clarke**. I think you could very well see that.

Senator **Shelby**. Any comment, Mr. Heller?

Mr. **Heller**. No. I agree with that.

Mr. **Seidman**. I agree also.

Senator **Shelby**. My time has expired. Thank you, Mr. Chairman.

The **Chairman**. Senator Bond.

Senator **Bond**. Thank you, Mr. Chairman.

I'd like to have the comments of all three witnesses on a question that has been raised a good deal. It's about the dual banking system. There are some who have observed that it's maybe unwise public policy to let the States experiment and grant additional powers to State chartered banks when it's the Federal Government that picks up the tab for deposit insurance.

ROLE OF STATE GOVERNMENTS

What do you see the proper role for State governments in the structure and regulation of our financial system? Bill, why don't you start?

Mr. SEIDMAN. Senator, we think that the dual banking system is of great benefit to the stability of the country's financial system, particularly the consumers because it allows States to tailor their banking system to meet the needs of their areas.

That raises the question about whether they are jeopardizing the insurance system through things that they may authorize. We think that that can be properly controlled through deposit insurance. If States begin to do things which jeopardize the system, then their banks simply will not be entitled to deposit insurance.

Given that as the overall safety net, I believe that the dual banking system is essential to good consumer services and I would certainly hope that all the legislation will take that into consideration.

Senator BOND. Bob, do you have a comment?

Mr. CLARKE. I would concur, Senator, that the dual banking system has served us very well. It provides an opportunity for some healthy competition; if the Congress does not provide certain operating authority for national banks and legislatures feel that it's important for the consumers in their State to have particular banking services, they can choose to provide them.

Senator BOND. Mr. Heller.

Mr. HELLER. I agree with that as well, but let's keep in mind that the States should authorize these activities within their own borders. The abuses we have seen in the past—like the infamous South Dakota loophole—are the kind of activities I think that we don't want to see in the future and that effectively have been stopped. So within its own regional constraints I think the States should be free to determine the proper powers for individual banks.

Mr. CLARKE. I'd like to add a footnote to what I just said. While I very much support the notion of the dual banking system, I think the Congress needs to recognize that there is a potential for tremendous competitive inequality if State banks are allowed to do a variety of things that national banks operating in the same State are unable to do.

Although I very strongly support the bill this committee wrote that has now been passed by the Senate, there is one aspect of that bill that, in my judgment, is terribly damaging. That is the insurance provisions which set the stage long-term for wide disparities in competitive equality between national banks and State banks. If enacted, they could lead to depreciation in the value of a national bank charter, which I assume this committee would not like to see happen. I certainly would not like to see it happen, and I don't think it would be good as a matter of public policy.

Senator BOND. There are arguments we hear frequently that the Federal and State chartered S&L's were given far more powers than they should have had and they abused them and now we're looking at a multibillion bailout for FSLIC.

Do you think there's been a connection between deregulation and the difficulties that some of the savings and loans have found themselves in, Mr. Heller?

Mr. HELLER. No. In the long term, greater diversification will clearly serve the banking system by providing greater stability. But certain activities that particular savings and loans engaged in were certainly ill-advised, especially with the benefit of hindsight.

Some made essentially a straightforward run into areas where they were not well prepared to assess the risks; that, I think, constituted the danger that resulted in the bad S&L performance.

Senator BOND. My time is up but I'd offer you a chance just to comment for Bill or Bob.

Mr. SEIDMAN. I would say, if I might, that the problem was much more a failure of supervision than it was of legislation and it was a failure of supervision both at the State and Federal level.

Mr. CLARKE. I would just——

Senator RIEGLE. Would you just yield on that question?

Senator BOND. I'm done.

Senator RIEGLE. Would the chairman just allow a followup on that because that's a pretty serious point and what I'd like to know is the failure of supervision not enough supervisors, incompetence?

Mr. SEIDMAN. It think it was a system that simply wasn't prepared to supervise almost an entirely different kind of business which was being authorized by allowing more powers. They didn't have the manpower. The State wasn't set up to do an effective job. When they sought more manpower at the Federal level they ran into overall administration problems that didn't allow them to put people on. I think it has to be recognized that the troubles in that fund were caused by 15 percent of the units, not by any great majority. It was a failure to get that 15 percent that caused the problems.

Senator RIEGLE. Well, Mr. Chairman, it seems to me if that's the case that may also say to us as we legislate further as we're about or trying to here that one of the parts of the legislation ought to be to make sure that the regulatory structure is going to be there in sufficient amount and strength and competence so that we don't repeat this thing again. It sounds to me like you'd better gear the system to handle the new services before the fact and not catch up with it after the fact.

The CHAIRMAN. That's one of the reasons why we have in our Glass-Steagall repeal bill postponed the time for the underwriting debt and underwriting equities, so that the regulators can have the manpower trained and ready to go.

Mr. SEIDMAN. We've already moved to begin building our force by 25 percent with that view in mind, plus doing a better job in regulating.

The CHAIRMAN. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman. This has been a very instructive panel.

I'd like to followup on three questions that have been raised. First, the most recent question. As the chairman said, there was a sensitivity to the need of simultaneity between the regulators and the additional powers for commercial banks in the banking bill that this committee reported and the Senate has now adopted. I would appreciate it if each of you would continue to monitor that situation given what might happen further down the stream in the legislative process to alert us to any concerns that you might have as to regulatory resources that this new legislation and empowerments might entail because we don't want to repeat in the commercial banks what Mr. Seidman has indicated he thinks we went through with the thrift institutions.

That's a statement and a request for future help.

Second, Mr. Seidman, in your response to Senator Bond's question about the dual banking system, there was a comment made of concern that some of the States may be granting additional powers to their banks which would create a competitive circumstance. I think Mr. Clarke made that point.

One other issue to this, in addition to competitiveness, is the difference in the actual risk which your fund undertakes if banks are in fact somewhat different institutions—and that word doesn't have a common meaning in terms of powers.

You suggested in your statement in appendix D the possibility that there needs to be an increase in insurance premiums for large banks, which I interpret as meaning some form of a differential in premium rate based on assessment of risk. Did I interpret what you said correctly? And if so, does that indicate that you believe there is the methodology available for a risk-based premium system?

Mr. **Seidman**. That particular section, Senator, was addressed to the problem of what we call the large bank-small bank problem: How do we have a more equitable system since in fact we have been protecting all depositors in large banks, and how do we have a system that might be more fair to all banks? That particular section laid out about six or seven different ways that we might proceed in that area and pointed out some of the advantages and disadvantages of each.

So we weren't advocating that. What we were trying to do was put out for discussion with the bankers what might be the appropriate way to meet that.

Given that, we do believe that there are risk-based premiums proposals that could be put before the Congress and we would particularly point out, as Governor Heller has, that the unit banking system has tended to be expensive to the insurance fund because of lack of diversification of banks.

Senator **Graham**. Your counterparts at FSLIC are less optimistic about developing a risk-based system for their responsibilities. I wonder if in the course of your considering this you might meet with your colleagues and see if together you could pursue this because to me it really is irrational to have the same premium where clearly there are significant differences in risk and where by having the same premiums you actually might even induce people to do riskier things and attempt to secure greater powers to speculate realizing that it doesn't cost them any more in additional premiums and they've got the same insurance network under their activities as the safest and most prudent institution.

Mr. **Seidman**. We agree with that analysis, Senator. Our problem has been that it is difficult to come up with a formula that doesn't require judgment of the regulators, and the judgment of the regulators is a difficult way to assess premiums or taxes.

Senator **Graham**. I recognize that and Lloyds of London for several hundred years has had to make millions of judgments as to relative risk in areas that would appear to a layman to be even more difficult than the kind of judgments that a financial institution regulator would have to make.

Mr. **Seidman**. Yes, sir. The problem is that in our case we're a monopoly. There's no place for them to go if they don't like our judgment.

Senator **Graham**. Well, maybe some creative suggestions of how to create that would——

Mr. **Seidman**. We've been discussing this.

Senator **Graham**. Could I just ask one last question, Mr. Chairman, relative to Third World debt? There was an article in the papers in the last day or so about the negotiations with Brazil and the encouragement of commercial banks which already have substantial loans to that country, some of which have not been serviced on a sustained basis, to increase their lending in that country.

What's your feeling about efforts by either national groups such as the Treasury or international organizations such as the IMF to be pressuring, if that's the right word, commercial banks to increase their lending in Third World countries?

Mr. **Heller**. Well, basically, it's an agreement that the banks and the countries have to arrive at on their own. What we have tried to do in years past, is to be helpful in the negotiation process. We have tried to bring the parties together and sometimes make constructive suggestions. But in the end, the decision to lend or not to lend really is a decision that has to be made by the individual commercial banks.

Senator **Graham**. Thank you, Mr. Chairman.

The **Chairman**. Governor Heller, you say on page 11 of your testimony:

> The ratio of primary capital which include loan loss reserves to total assets for all insured commercial banks increased 49 basis points to 7.8 percent at the end of 1987. It seems to me that much of this increase was accounted for by loan loss reserves as a result of special LDC provisions. National City Bank made a sensational increase in their reserves."

SHOULD LOAN LOSS RESERVES BE COUNTED AS CAPITAL?

If we subtract the loan loss reserves from the capital we find that the real equity capital is only about 5 percent. Do you really think that reserves put aside to cover losses on a particular category of loans should be counted as capital? If the regulators count those reserves as capital, aren't they giving a false picture to the real strength of these institutions?

As I understand it, there used to be an advantage for the banks because of the tax situation in building up their reserves. That advantage has disappeared now and the reserves I think can be considered as legitimate offsets against an expected loss, particularly in view of the fact that the loans by the LDC's are written down by the market. So isn't it an overstatement of the capital when you say it's increased and that it's at a level of 7.8 percent?

Mr. **Heller**. Yes, Senator, I agree with you. In the previous paragraph in my written statement I point out exactly what you are pointing out, namely that the average ratio of equity capital, excluding the loan loss reserves, has declined from 5.1 to 4.3 percent and that essentially——

The **Chairman**. Of course you say that. The ensuing paragraph that I referred to, however, makes it appear that you're talking about a capital which included the loan loss reserves, that you overstated the reserves.

Mr. **Heller**. Well, I wouldn't say overstated. Both the reserves and the capital are there to cushion potential loan losses, to protect the depositors from any adversity that the bank might encounter.

The **Chairman**. If I might interrupt, it just seems that the reserves, particularly with respect to the LDC's, are simply acknowledging a fact of life. We know what those losses are pretty much. Certainly nobody expects them to be able to make good 100 percent, isn't that right? Aren't those reserves that were taken pretty much prudential? As I say, there wasn't any tax advantage and they just did it because it was a recognition of the situation.

Mr. **Heller**. That's right, but one other thing I think we ought to take into account in the LDC reserving is that it is very much up to the willingness of the borrowers to service these loans. The actions of the borrowers themselves can influence the quality of the assets that the banks have on their books. In that sense it's a little bit different from regular commercial problems that may be encountered.

As a result, there's an unusual amount of judgment in proper reserving when it comes to these LDC loans. But I fully agree with you——

The **Chairman**. There's also a market in them so that you can tell that the reserves were quite accurate and responsible and weren't overstated and I see no advantage in their overstating them now.

Comptroller Clarke, let me ask you this. We note that chart of capital for banks have different size categories. It looks like a geologist's map of rock strata. The big banks are at the bottom of the heap with relatively the least capital and the smallest banks are at the top with the largest capital to assets ratio. I also note that the Federal bank regulators show a greater propensity to bail out large banks rather than small banks. Small banks get closed. Large banks get bailed out.

Which way does the causation run? Do the regulators bail out large banks because they have less capital or do the large banks carry less capital because they trust they will be bailed out, not closed?

Mr. **Clarke**. Mr. Chairman, I would say that neither of those is really the case.

You're correct that if you look at a chart showing the various size categories of banks and their capital levels, quite often you find the smaller banks with the higher capital levels. Most of the time it's strictly a choice by those smaller banks to operate with larger amounts of capital. That's a historical tendency that has always existed. Also, given the more concentrated markets they serve, and the fact that a smaller bank could be severely impacted by a downturn in such a market, as we have seen, it is probably prudential for smaller banks to carry higher capital levels.

I don't think the motivation to operate with higher or lower capital levels has anything to do with the extent to which assistance might be provided. When there is any kind of FDIC assistance provided, the bank has either failed or is failing, and the stockholders are going to lose either way. So from a stockholders' standpoint, there's a motivation to maintain as much capital as possible.

The **CHAIRMAN**. My time is up.

Senator Gramm.

Senator **GRAMM**. Well, Mr. Chairman, I want to follow up on your question with a slightly different twist in it. I guess one of the biggest complaints I get from banks in little towns in my State, whether they're national or State banks, is their perception of differential treatment. They complain that if you get in trouble in Muleshoe or Cut And Shoot or Ben Wheeler or some place like that, that you're likely to have the bank just completely closed down and have the building sold off to the local real estate dealer; but if you get into trouble in a big city, that the economic entity goes on. I think most people realize that the stockholders walk away with nothing, but obviously to a smaller town a bank is more than just an investment.

Now I realize that obviously part of your job, for example, Mr. Seidman, is protecting the FDIC, and you're not in the welfare or civics business. When a big crisis occurs you try to protect your fund, and I understand that.

But I'd like to get both your reflections and Mr. Clarke's reflections on the view that is expressed by a lot of country bankers. Their view is that in some cases these smaller rural banks, if they got some open bank assistance, even though the stockholders might walk away with nothing, could become going concerns again in these rural areas. Their view is that it's just easier for you all to come in and shut them down and liquidate the assets, whereas it's impossible in the big cities with the big banks, and so there is a differential treatment here.

Give me your response to that. Why don't you start, Bill?

DIFFERENTIAL TREATMENT

Mr. **SEIDMAN**. Well, Senator, I would respond that, yes, there is a differential treatment in some cases and there is an inequity in some cases. I believe I said that in my hearings for confirmation. We have worked very hard to try to make that differential as small as possible. In every case where we can get another bank to take over a failed small bank, we do so, and we are successful in about three-quarters of the cases. So that the fact of the matter is that the great majority of small banks are treated exactly the same way as big banks are treated.

The problem comes generally with very small banks where there is no private banking entity that is interested in taking over the situation no matter how we might participate to help. In those cases, we have the alternative either of taking that bank over ourselves and running it, since there are no private institutions that want it, or closing it down. Very often it may be simply an economic entity that never should have been created and is simply not viable as a bank in that particular area.

So when it comes to the actual uninsured depositors who are harmed by this problem, it's less than 1 percent of the total deposits that we handle. So given all of that, one has to say that there still is some inequity there. That's the list that I attached to my testimony indicating some ways that we might be able to meet that. Each of them has substantial disadvantages such as insuring all deposits, such as the FDIC becoming an RFC and operating to help banks who are about to fail. There are many ways that we could move in that direction, each one of which has substantial detrimental effects on the system.

Senator GRAMM. Bob?

Mr. CLARKE. Senator, I couldn't really add much to that. I think that Chairman Seidman has outlined the position very correctly.

The only thing I would say in addition is that the FDIC has been attempting to come up with additional creative ways to help the smaller bank. There have been 14 open bank assistance transactions so far this year. This is way ahead of where the corporation was the same time last year, and, with the exception of the First City assistance, all of the transactions have involved small institutions. In the capital forbearance program, which now has a large number of participants, mostly smaller institutions, we have tried to tailor our regulatory approach to deal with the small bank as well as the large bank. But you're quite correct; there are still some inequities, and it's very difficult to make those go away.

Senator GRAMM. Well, let me just make an observation. I understand you have a difficult and important problem, but my pitch is this, that regulation, like government in general, works better when it's perceived to be fair. I think the better job you can do in eliminating this perception and the reality of inequity, then the better the people that are being regulated, and regulated in a very difficult period for them, the better their reaction is going to be to it.

Mr. CLARKE. I agree.

Mr. SEIDMAN. I agree with that.

The CHAIRMAN. Thank you, Senator Gramm. I particularly thank you for a very wise and fair and just observation.

Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

Chairman Seidman, a while back you responded that you were inclined to agree with the estimate on the savings and loan insolvency of somewhere between $20 and $60 billion or thereabouts and that basically we're all on the hook for that because of the Federal deposit insurance arrangement that means the taxpayers are really liable to pay that money when that bill comes due.

If we were just for the sake of the illustration to say that the insolvency is $40 billion and that's the mid-point between the $20 and $60—I suspect it's higher, but let's say it's $40 billion. That's a huge amount of money and it's a monstrous mistake, if you will, if this was avoidable. And it sounds to me as if in large measure it was avoidable and given the fact that there are some special regional economic problems and what have you, pointed to earlier was to the effect that there was sort of a regulatory failure breakdown in your view and that if the regulatory supervision had been what it should have been or might have been that we could have avoided a large part of that problem. I mean that's what I understood you to say. Am I right in reading your answer that way?

Mr. SEIDMAN. That is correct, Senator. That certainly was a substantial factor, in my view.

Senator RIEGLE. Well, the thing that astonishes me when I think about it—and I want to go on to other things here because we're going to have a lot of time to spend on the savings and loan problem to work our way through it—but, Mr. Chairman, the notion that in a sense the American public is on the hook for a $40 billion loss which is a reasonable estimate here because the regulatory structure really didn't work properly and this problem was allowed to sort of get away and roll up these kinds of losses, some people tell me that if we don't deal with the savings and loan problem this year and if we wait another year that figure could be $100 billion, that the figure is growing; it's not diminishing.

I think we hear about contracting problems in the Pentagon where maybe a half a billion dollars is lost or misappropriated in some fashion. Here we're talking about a figure of probably $40 billion or higher. I think when it really sinks into people what this is, I know you've given Golden Fleece Awards over the years for a lot of areas where government waste has occurred—I don't know how we would even devise a Golden Fleece Award sufficient for a $40 billion error.

The CHAIRMAN. What's especially appalling in view of the fact that this is occurring at a time of national recovery, when the economy has been stable and progressing. It's true that we have a grim situation in the Southwest, but overall the country is doing well and in most States the financial institutions are doing well. What haunts me is that Texas today may be the United States tomorrow if we have a recession, unless we have extraordinarily increased prudence among the regulators, among other things.

Senator RIEGLE. Well, does anybody want to make a response?

Mr. CLARKE. Senator, I know you and I share the same concern about the adequacy of supervisory resources because we've talked about it before. I've said many times that deregulation doesn't mean desupervision. You still have to have strong bank supervision and you have to have structural mechanisms in place to protect the safety of depository institutions. That's why the committee incorporated the so-called firewalls in the recently passed bill. People can disagree about the need for some of them or whether you need more of them, but the fact is you said we need to separate deposit-taking institutions from other activities because of the risk that may be associated with them. That separation was not present in the deregulation of the thrift industry to the same extent. Similarly, you have to have good people and you have to have experienced people as bank supervisors. Finding and keeping such people are concerns that various members of this committee have expressed to me before, and you and I think it's something we need to be very alert to.

Senator RIEGLE. Well, we went through the fight to get your agencies out from under the straitjacket of the Gramm-Rudman-Hollings Act because that had the crazy effect in self-financing agencies of preventing you from being able to hire the people you needed. We finally got that taken care of, but it didn't come easily and it took a long time to do it.

Let me ask you this question and let me start with you, Chairman Seidman. Why should the Federal Government put Federal deposit insurance under any activity that is not authorized by the

Federal Government, whether it's a savings and loan system or any other system, why should we allow States to stretch out the activities and we at the Federal level in effect de facto allow the Federal deposit insurance to be stretched out under those activities? If the taxpayer is going to be on the hook for this in the end, why shouldn't we level off the activity and exposure that is going to come back on taxpayers of this country?

Mr. SEIDMAN. Well, I think you're pointing out, Senator, what is the basis of all of this problem, and that is when you allow an institution to borrow on the credit of the United States somebody had better find out what they're doing with the money.

To answer your question, it seems to me that you have taken control of that. That's what the FDIC is for. The FDIC has the power to say to any institution, "If you want our insurance, then you must operate in a safe and sound manner." Therefore, we have the power to look at a State and if they authorize the funds to be used for obviously high risk purposes, we have the power to say either you can't do that or we can wall it off so it cannot affect the banking system. So the Federal Government has in fact created a vehicle to do exactly that.

That was what the failure was, unfortunately, I think in the other industry.

Senator RIEGLE. Well, have there been any cases where the FDIC has said to a State, "You've gone too far?"

Mr. SEIDMAN. Yes, and we have said that certain kinds of activities have to be done in a subsidiary so that those activities cannot jeopardize the bank and we will police the wall between the two and look at States all the time in that regard and review whether or not they are authorizing things that we believe makes their banks unsafe and unsound.

The CHAIRMAN. For the record will you provide the specific instances to the committee?

Mr. SEIDMAN. Yes, sir.

Senator RIEGLE. My time is up.

The CHAIRMAN. Mr. Seidman, on page 25 of your testimony you discuss the FSLIC fund. You say:

> If additional funds are required by the FSLIC in the future, we believe they should be supplied without endangering the financial condition and capacity of the FDIC. We do not believe a merger of the funds is desirable under current conditions.

That statement implies that there are conditions in which you might see a merger of the fund to be desirable. Can you tell us what those conditions are?

CONDITIONS FOR MERGING THE FUND

Mr. SEIDMAN. Well, first and foremost, Senator, if in fact the two industries are going to become equal in the types of charters they have and the kind of business they are in, it seems to me they ought to be regulated by a common regulator and ought to be then in a common insurance fund. As long as there's a separate industry with a separate purpose, then it seems to me that the industries are better off to maintain separate insurance funds and separate regulation.

The CHAIRMAN. Then are you saying that the conditions would be that the merger would only take place if we no longer have savings and loans as such, that they become commercial banks?

Mr. SEIDMAN. That would be one condition. Now there are different definitions of merger. You could have an administrative merger which would operate with one head board or whatever the Congress wanted over two separate funds, but they could administer common standards, common supervision, common property disposal, but still maintain rates and funds dependent upon the risk in the different industries.

The CHAIRMAN. Do you recommend that?

Mr. SEIDMAN. Well, I think under current conditions we are not ready to move in that direction, but if in fact the other industry, the S&L industry, believed that that would be a satisfactory answer, then we would certainly be pleased to look at it.

The CHAIRMAN. In that case, you would merge the funds?

Mr. SEIDMAN. Well, again, I don't believe the financial funds can be merged until the problem of the S&L industry deficit is taken care of and, if the industries are going to be in different kinds of businesses with different risks, then I think they ought to have separate funds and separate premium rates to reflect the industries that they are in.

I think there are a lot of benefits possible, certainly in things like property liquidation and common standards and supervision.

The CHAIRMAN. Governor Heller, in a recent report by Mr. George Salem, a banking analyst for Prudential Bache, there's a table showing the exposure of various banks to leveraged buyout loans, LBO's. That's rather frightening. That table shows, for instance, that one bank has made a leveraged buyout loans that are 135 percent of their shareholders' equity. Others are not quite as high. Some are active in reselling these loans. But the involvement is frightening when you consider the possibility of a recession reducing earnings in the usual cyclical manner.

My question is, are we about to begin an era of widespread rescheduling of loans to corporations who are up to their ears in debt and aren't we likely to be awash in bankruptcies at the next downturn of the economy?

Mr. HELLER. Senator, we share your concerns. In my written testimony I identified leveraged buyout activity as an area that bears close watching and it's certainly an area that the banks have gotten into recently.

The CHAIRMAN. You say close watching. Would you elaborate?

Mr. HELLER. It means that our examiners are trying to identify the activities in the various banks, see how much it is in relation to the total capital that the banks have, and discuss with management whether the risk assumed is appropriate under the circumstances.

The CHAIRMAN. Then you would discourage the kind of situation I described here with 135 percent of their shareholders' equity in leveraged buyouts?

Mr. HELLER. Well, that's certainly a very high number that you are mentioning there.

The CHAIRMAN. Do you think this constitutes a major threat to some of our banks?

Mr. **Heller**. I wouldn't call it a major threat. You correctly said it becomes a threat under very adverse economic conditions. We don't foresee those adverse economic conditions developing at the present time.

It is perfectly proper for banks to participate on a reasonable level and on a prudent level in this leveraged buyout activity, but if they do so excessively, that becomes a matter of concern.

The **Chairman**. My time is up. Senator Riegle.

Senator **Riegle**. Mr. Chairman, I'm just doing some quick math here and I haven't had time to double check it, but if I'm right on the $40 billion exposure, if we have to take that hit for the savings and loan system and spread it across the country, that's $160 a person if you take a population of 240 million people. You're the accounting whiz, Chairman Seidman. You can probably run these numbers backward and forward best as I say them here. But for a family of four, that's $640 that they are on the hook for here and I must say I think when it dawns on people what's happened here the scale of this problem starts to dwarf a lot of other things that we think of as financial problems because there's an immediacy to this one and the fact that it seems to be getting worse, not better. So that the longer we wait to solve it, the more it's going to cost us to do it.

I must say, Mr. Chairman, I really get uneasy about the notion of just seeing that problem float on into the next year and the next administration. I think we ought to have some kind of a very tough blunt action plan developed now because I think if you can save $10, $20 or $30 billion in losses that otherwise will be added on here because this thing is being papered over, that we owe it to the country to do that. So I think we're onto a major problem here and, unfortunately, we don't yet have the answers and certainly we're not going to get them today in this setting.

I want to move to a different point and that's the growth of Japanese banks and the power of Japanese banking worldwide. Earlier when one of you used the list of the 50 largest banking institutions in the world, it really starts to show the relative size and backward slide of American banks vis-a-vis the growing power of other international banks and of course the Japanese are becoming more and more the bankers of the world, and they're doing that largely because they're loaded with money that used to be ours and is now theirs. We've got the video recorders and the Toyotas and a lot of other things and they've got the money and there's a big difference if you're holding the capital or you're not holding it.

I'd like your assessment of the degree to which this growing strength of the Japanese banking industry is beginning to create a kind of competitive difficulty for American banks. It's hard for me to see how we're going to be able to in a sense be leading international banking powers if our relative performance as against the Japanese, just to name one, is changing as radically as those numbers suggest that it is and where they are in strengthening positions and our banks are not adding strength anywhere near the extent and speed which they are. So doesn't this pose some threat to our banking system over a period of time if you think about banking on a global basis?

Mr. Seidman, why don't you start on that?

Mr. SEIDMAN. I believe it's a challenge to the system and I think it's a challenge that can be met. I think in looking at those numbers and those kinds of things, one has to remember that our banks are not banks for our whole country. Our banks have not had the base that the Japanese banks have in terms of being able to be a bank which has as its base the entire country. That's one of the reasons why our banks have been limited in size relative to banks in Japan. I think the Japanese banks would be good competitors. I think if we can get them on a common capital basis so that it is fair competition, that in the long run—and we remedy some of the problems which the Senate bill does and others—we will be able to compete in that world. As long as we have a restricted system and we handicap our competitors, we're going to see the continued emergence of Japanese banks.

Senator RIEGLE. Why wouldn't the Japanese banks be smart to come in and buy up at bargain basement prices American banks? You've got this huge variation of the dollar versus the yen. It seems to me you've got banks selling at very low price-earnings ratios right now. It seems to me the Japanese if they wanted to could come in here and basically pick off any number of banks, take major positions, if not in fact take over the whole bank, for whatever purpose they wished, they could. Whether to put the bank out of business as a competitor for the long term or to run it sort of as a kind of a vessal operation or whatever it happens to be. Why aren't we in a position where that kind of possibility is now something that faces us?

Mr. SEIDMAN. Well, I would answer first that they are buying banks. They do see the bargains. I don't believe that they are going to move in the way that you have indicated because I think that that would bring a reaction from the Congress and the administration that they don't want to see. But as far as an economic matter, there's every basis for them to do just that.

Senator RIEGLE. And there's no law that prevents them from doing it now, is there?

Mr. SEIDMAN. That's right.

Senator RIEGLE. Mr. Chairman, my time is up.

The CHAIRMAN. Well, I just want to make a statement and then ask some question and then I'll let you go, but I must say that I think that Senator Riegle has made a tremendous contribution in the last few meetings particularly—not that he hasn't before, but I must disagree with him very strongly on the size of the Japanese banks. That doesn't bother me one bit. They are Sumo wrestlers compared to Mike Tyson. Because they're big and fat doesn't mean that they are good. The strongest bank in Japan I understand is the 28th biggest bank which is Bank of Tokyo, which is the strongest bank according to Paul Volcker in international competition. As you say, they've got 137 banks. We have 14,000 banks and I don't think you can measure efficiency on the basis of the assets you have.

Now I'd like to get into another point, however. Mr. Seidman, you made the point that the condition of our banks is shaped by the condition of their customers. I think you are partly right. Certainly unpredictable recessions and the unpredictable timing of the business cycle can have a very sharply suddenly diminishing effect on bank assets, but banks are supposed to provide an element of prudential caution in our economy. If real estate developers in the Southwest were caught up in a go-go psychology, shouldn't the banks have exercised more caution in financing these unsustainable ventures? And should not the regulators have leaned harder on the banks to be less exuberant than they've been? It just seems to me that it's not enough to say that Texas is go-go. It seems to me it's up to you to tell them to be slow-slow.

Mr. SEIDMAN. I can't disagree. I believe that's correct.

The CHAIRMAN. Why haven't we had more restraint on the part of the regulators?

Mr. CLARKE. Mr. Chairman, I would be glad to comment on that.

One of the problems you have is trying to strike the right balance between credit allocation and prudential lending supervision. You have to be very careful, I think, not to limit banks too much in the types of credit they can extend. Obviously what credit they do extend should be extended on a prudential basis. Banks should have good underwriting policies internally and follow all of the basic rules of good banking practice, but you have to be very careful in limiting the extent to which banks can lend to a particular industry.

The other comment I would make is that a good loan today could very well be a bad loan three or four years from now if a market has deteriorated. That's not to suggest that banks didn't make some bad credit decisions; there's no doubt about that. But, some of those credit decisions were ones that any of us would agree were prudent at the time they were made. The market simply changed, causing what were good loans to become bad loans. That's the reason that you're seeing the intensity of the problem in the Southwest; the depth of the decline has reached even the good borrowers.

The CHAIRMAN. Let me get into another area very quickly. The press has been stressing the increasing role that banks are playing in financing mergers and acquisitions. Many of these mergers substitute debt for equity on the acquiring company's balance sheet. This process has the potential to weaken our economy. This has caused Borg-Warner, for example, to go from a three to one equity-debt ratio to a one to twenty equity-debt ratio, where obviously they are really vulnerable.

Are you concerned about the part the commercial banks are playing in takeovers, Comptroller Clarke?

Mr. CLARKE. I'm concerned about any kind of concentration that produces high risk for banks. As with leveraged buyouts, merger and acquisition financing in itself is not necessarily bad, but there are good merger and acquisition financing credits and there are bad ones. Also, you can have banks concentrate too much in the area of holding leveraged buyout credits or merger and acquisition financing credits. You simply have to look at the bank on a case-by-case basis. I don't think you can generalize and say that merger and acquisition lending is bad. But too much of it by a particular bank or bad underwriting practices by a particular bank can be bad and do concern me.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Mr. Chairman, I'd like to pose this question. Yesterday we had a hearing here and David Ruder, the Chairman of the SEC, sat where Mr. Heller is sitting today and he told the committee that he was concerned and he stressed the fact that he was concerned that we could have another market break such as we saw in October and that he wanted to see additional steps taken to prevent that or to guard against that or to make it less likely to happen.

Let's hope it doesn't happen, but going back to October of last year when the market did crash and the pressures that hit the banking system in those 2 or 3 days in October. I'd like you to reflect a little bit on what happened then and how severe a test that may have been for the banks, particularly the banks that are connected to financing the financial markets, and if we were to have another one—no one is predicting that, but there's a good bit of apprehension about it—should we get another test like that now, what are the implications for the banking system and what do we need to understand about what an event like that might mean in the way of risk to the banking system or to part of the banking system? I'd like you, Mr. Clarke, and also Mr. Seidman to answer.

Mr. CLARKE. It seems to me, Senator, based on the research and the studies that we've done since October 19, that the banks performed very well and that they did provide liquidity to the system during that time. I would assume that they would perform well again should that happen.

LIQUIDITY PROBLEM

Senator RIEGLE. Could I ask you just one thing with respect to that. My sense for it is that there was a pause in the flow of credit to major stock market institutional companies and that in fact the Fed acted to enable the banks to act, but there was a moment there when before those connections were made there was a real liquidity problem that had developed. Is that not so? I don't know that you would have meant to leave that out, but you do not feel that that was the case.

Mr. CLARKE. The Fed was, of course, very supportive during that time in making certain that liquidity was available. There's no doubt about that.

Senator RIEGLE. But was there liquidity prior to the time the Fed acted? I was under the impression that we really had a hitch develop in the system until such time as the Fed came in to really give a very strong signal to the banks that enabled the banks to continue to finance the activity in the stock market. Is that not right?

Mr. CLARKE. My impression, Senator, is that the liquidity was there but that there was definitely encouragement from the Fed to provide additional liquidity that was very helpful.

Senator RIEGLE. Mr. Heller.

Mr. HELLER. That's right. Banks cannot stand alone in such a situation and the Federal Reserve immediately made it clear that we were ready to provide liquidity to the banking system and in return the banking system was then in the position to provide the liquidity to the dealers, the stock brokers——

Senator RIEGLE. Isn't that another way of saying that the banks when they were tested in October were not sufficient by themselves to handle that problem until you folks responded in an extraordinary way yourselves?

Mr. Heller. Well, it's the very function of a central bank to be present at that particular moment.

Senator Riegle. I fully agree. I'm glad you did. But I just want to make sure I understand the sequence of events and if I'm—my understanding is that banks reached the point where they could not handle the problem by themselves without your extraordinary help. Isn't that correct?

Mr. Heller. I think if you would take away the central bank of the country, then indeed we would be in a very, very difficult position in an extraordinary situation like October 19, but nobody is proposing that. So as long as we do our job and the banks do theirs, I think we can manage even situations of such extraordinary nature.

Senator Riegle. Let's hope that's right and that's certainly the mechanical way in which we do it. I want to follow up with Mr. Clarke.

Mr. Clarke. I did not want to leave the impression that the banks had run out of liquidity until the Fed provided some encouragement. I don't think that's true.

Senator Riegle. So your testimony would be that there was not a hitch there where all of a sudden there was a problem in terms of intermediaries in the financial markets finding that they were not able to really function because there was a shortfall of credit until such time as the signal really was given to the banks from the Fed?

Mr. Clarke. It's my understanding that there was sufficient liquidity in the system to meet the demand.

Senator Riegle. Yes, but I think you're sidestepping me. Obviously there was because we got it done. The fact was the system began to break down and every bit of reading that I've done and the testimony I've heard from people and comments I've heard from people who were involved in it was that there was a period there where the major market makers were finding that their credit lines were out to the limits and the banks for a period there sort of held back until the signal came from the Fed.

Mr. Clarke. That's a different issue, Senator, than saying that the banks were out of liquidity. Market makers' credit lines may have been used up and there may well have been some hitches in that regard, but I want to make sure that we don't leave you with the impression that the banks were out of liquidity, that they were unable to fund the credit lines.

Senator Riegle. The concern that I have and I think that it's important that we find a way to pursue today or some time, is that the market system very nearly shut down, as you may well know. I mean it came within an eyelash of shutting down and that's been well documented at hearings before this committee. One of the reasons it nearly shut down is that the liquidity system began to be strained beyond its capacity to function at a point in time and the connection between the market makers and the banks were part of that problem and but for the Fed intervention we probably would have had—you're nodding in the negative——

Mr. **Seidman**. Well, I met with the Brady Commission, Senator, and spent some time with them and I must say I did not come away with the impression that the only reason that——

Senator **Riegle**. Nobody is saying it's the only reason.

Mr. **Seidman**. Or the primary reason that the banks were able to handle the situation was the action of the Fed. I think the banks were looking at a traumatic situation and they stepped back to take a look at it, but not on the basis that they weren't willing to go forward and obviously they expected the Fed as the lender of last resort to be available. But I think it would be unfair to come to the conclusion that we had a liquidity crisis that the banks couldn't handle.

Senator **Riegle**. Well, we could pursue this and I think we've all stated our point of view and there are some differences in point of view here. My real concern is what would happen if we got tested again here and have the conditions changed? Are we in a better shape to take that kind of a shock should it happen? Are we in the same shape or worse shape? I mean if we got hit like that again, do you feel confident, all of you, that we could sail right on through it?

Mr. **Seidman**. Well, I would say the banks are in somewhat better shape. They gained liquidity as a result of the last problem and therefore they are in somewhat better shape to deal with the situation.

The second thing is that the markets are not near so high on an historical basis which at least gives some confidence in terms of what size the problem would be.

Mr. **Clarke**. Also, securities firms as borrowers have thought through as a result of October 19 what their future needs might be, and lenders have thought through with them what their capacity to fund those needs would be. I would say that probably we are in better shape to deal with that kind of a situation today than we were on October 18.

Senator **Riegle**. Mr. Chairman, my time is up. I have one other question I want to ask when you finish.

The **Chairman**. Well, I've got a lot of terrific questions that I'd like to ask but I'm not going to ask them because the time is late and you've been very patient. Senator Riegle, you can go ahead with your one question.

Senator **Riegle**. This is just one other topic, but I think it's important we cover it today, and that is the recently concluded agreement on international capital standards for banks. We really haven't gotten into that today but there was an article in the Washington Post the other day that indicated that our 12 largest banks would have to raise in the aggregate some $11 billion to meet those standards and with price-earnings ratios being what they are today and just the difficulty of raising capital anyway, it's sort of hard for me to imagine how they might go about doing that.

Also, there was another article in the May 11 issue of American Banker that said that the Japanese banks might have to raise as much as $50 billion in equity in order to comply with the new international standards.

So it looks as if this would work in different ways, but I'm concerned here principally as to how it would work on American banks. Are we really in a position to sort of step up to that kind of requirement? Is that feasible in the short term here? Do you folks endorse that?

Mr. CLARKE. Under the proposed guidelines—and please remember that these are simply proposed—there is an international agreement that provides the framework for capital standards. That agreement in large part has been embraced by the three Federal bank regulatory agencies and put out for comment, but these are not final guidelines or regulations. There are additional refinements that have to be made both domestically and internationally before they could become effective. So this is not a done deal. It is not in place.

The risk-based capital proposal provides by its own terms that the banks would have until 1992 to get in compliance with the different capital requirements. One of the things the proposal does is address the concern that Senator Proxmire expressed—whether we should be including the loan loss reserves in primary capital. As you know, the proposal would differentiate between equity capital and other types of capital and would require that there be a minimum equity cushion irrespective of the size of the loan loss reserves.

The feeling is that we need to try to come up with a better way of measuring capital adequacy and we need to come up with a better way of providing capital, and I think we have done that in the proposal. It will require some of the banks to raise additional capital. Most banks—far and away the vast majority of the banks in this country—would already meet the guidelines were they in place today, but, as I say, the banks would have 5 years to get into compliance.

Senator RIEGLE. Do you dispute that statistic in the Post that says that the 12 largest banks would have to raise an aggregate of $11 billion to meet the standards?

Mr. CLARKE. Senator, we can't tell you precisely how much they would have to raise because under the proposed capital guidelines, off-balance sheet activities would be brought onto the balance sheet for purposes of measuring risk in individual institutions and we don't know exactly what the levels of those assets are.

Mr. HELLER. Senator, if I may interrupt for one second, that's really looking at it in a static way, the way the newspaper article you referred to is doing it; namely, to take the current portfolio of the banking organization and saying what capital requirements would be associated with that existing portfolio. But as you know, the international risk-based capital rules will lower, for instance, the capital requirements for the holding of U.S. Government securities, for interbank lines of credit, for various other classes of assets, and one would normally expect banks to rearrange their portfolios to respond to those differential capital requirements. So a bank may well go ahead and lower its commercial exposure and increase its holdings of U.S. Treasury bills and as a result the capital requirement with the same total asset size could well be lower than it is at the present time.

So it's very difficult to translate today's balance sheet into precise capital requirements. And as Mr. Clarke just said, first of all, they have 4 or 5 years to do it and, second, there are a lot of earnings that the banks can plough back into their own institutions.

Mr. **Seidman**. Senator, could I just make one comment? One of the reasons that we are in deficit is because we are applying it both to the banks and to the holding company. No other country is doing that and that is a fundamental difference in approach. And if we would apply it only to our banks in the way that the rest of the world is going to do it and deal with holding companies as an American phenomenon which is not part of this international business, then I think the numbers would be very much different.

The **Chairman**. Gentlemen, thank you very much. This has been an excellent panel. We are very grateful for your testimony.

The committee will stand adjourned.

[Whereupon, at 12:15 p.m., the hearing was adjourned.]

OVERSIGHT ON THE CONDITION OF THE FINANCIAL SERVICES INDUSTRY

THURSDAY, MAY 26, 1988

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10 a.m. in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle presiding.

Present: Senators Riegle, Dixon, Sasser, Graham, Garn, D'Amato, Hecht, Gramm, Bond, Chafee, and Karnes.

OPENING STATEMENT OF SENATOR REIGLE

Senator RIEGLE. The committee will come to order. Senator Proxmire is unable to be here this morning so I will be chairing the hearing in his absence.

Let me welcome all of you today. This committee first held hearings on the condition of the financial system in 1977 and today's hearing continues that tradition. The committee is very much concerned about reports of FSLIC's deteriorating financial condition, despite a $10.8 billion rescue package fashioned in the Competitive Equality Banking Act, CEBA, last year.

Today's hearing complements those that we held last week on this very same subject. Some of you were here for those hearings and, if so, you heard testimony as we did that the FSLIC is insolvent for the second year in a row. And this year the insolvency is twice as large as it was last year.

The panel of industry experts that we had here last week estimated that the potential cost of resolving the thrift industry's problems ranged somewhere between $26 billion and $64 billion and, of course, that is a very wide range. There are other estimates even beyond those.

They stressed that the cost of the cleanup is growing larger the longer we wait to deal with it. They also testified that in their estimation FSLIC most probably will need more funds in the near future than it currently has and it is said that there are three candidates to be looked at in terms of providing additional money. One source might be the healthy thrifts in the industry. Another source might be the banking system generally. And of course, standing behind it all is the American taxpayer that is liable for the money that's in the insured deposits.

In title IX of CEBA, Congress placed the full faith and credit of the United States behind the deposit insurance funds. No federally insured depositor has ever lost money in the United States and we in Congress are absolutely determined to maintain that record. So I want to say again, that no insured depositor in a savings and loan or in a commercial bank should have any concern about the safety and the return on schedule of their deposits that they have at those institutions. That's written in stone. That's a solemn commitment and it will be met.

At the same time, however, the problems in the industry I think have to be faced and dealt with and in order for the Congress to be able to satisfy our obligations in this area we need to know precisely the extent of the problem that now exists in the S&L industry and what the dynamics are that are taking us forward into the future.

We're seeing an increase in editorial comment. There was, for example, a concern about this in a comment in an editorial in Monday's Washington Post that states:

> Bailing out the savings and loan industry with taxpayers' money may be necessary at some point in the future but not this year or next.

That's the view of the Washington Post of this week.

I have one announcement to make before introducing our witness today and that is if anybody missed last night's televised game of the Pistons beating the Boston Celtics, I want to recommend it to you and if you can possibly get a tape that you get the tape and replay it and those of us from Michigan are justly proud not only because our team won and played very well but to beat the Boston Celtics is no small feat. We hadn't done it as the Detroit Pistons since 1982, so it isn't something that happens every day, but it was quite a game and those of us from Michigan are very proud of our team from Detroit and how well they played yesterday and hope they can do it again tonight.

Our witness this morning is well known to the committee because he served here with us for a long time in a distinguished way and he has many friends and admirers on this committee on both sides of the aisle. So this morning we want to welcome Danny Wall, who is the Chairman of the Federal Home Loan Bank Board and he has the tough job of coming in at this time, having come into the job not all that long ago, to deal with some of the problems that we're talking about today. So we look forward to your testimony and we'll have some hard pointed questions which I know you expect, but they will be offered to you in a positive way. So, Mr. Wall, we'd like to hear from you now.

Excuse me, I'm sorry. Senator Bond has come in and I see Senator Dixon. Senator Bond.

Senator BOND. With my apologies to my good friend, Mr. Wall, I thought perhaps I ought to set the record straight that spring has come, baseball is the national sport and we ought to be thinking about more appropriate things like that along with the savings and loan industry.

Senator RIEGLE. You're right. The Tigers won last night 4 to 1. [Laughter.]

OPENING REMARKS OF SENATOR BOND

Senator BOND. Your astrological signs must have been in the right juxtaposition because that sounds like a highly unusual occurrence and I think you are quite right to note that all those good things happened to Detroit. It is I guess a sort of a sign that every dog has its day. [Laughter.]

In addition, Mr. Chairman, to dealing with the immediate problems we face in the S&L industry, I hope that this committee will take the opportunity to rethink how deposit insurance functions. The systems worked well in the past in a stable, highly regulated and compartmentalized financial services industry. I'm not sure that it works as well in a deregulated environment.

It seems to me that charging all institutions the same premium and covering accounts to such a high level results in deposit insurance acting as a loss-sharing mechanism for the whole industry. Deposit insurance inextricably links the insolvent thrifts to the healthy ones and it links the banking industry to the thrift industry.

Are these linkages good policy? Should we be rethinking the linkages and how they work? I think there's a lot of work ahead on these issues and I'm pleased that we are starting and I look forward to the discussions we'll have today.

Thank you, Mr. Chairman.

Senator RIEGLE. Thank you, Senator Bond.

Senator DIXON.

Senator DIXON. Mr. Chairman, I'll put my statement in the record and I thank the chair.

Senator RIEGLE. Without objection.

I also have statements from Senators Sasser, Garn, D'Amato, Chafee, and Karnes that will be part of the record.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, this morning, the distinguished Chairman of the Federal Home Loan Bank Board will give this committee his analysis of the problems facing our thrift industry. I look forward to hearing his views.

As Chairman Wall points out, while the problems facing the thrift industry and the FSLIC insurance fund are very serious, we must not lose sight of the fact that the great majority of the industry is profitable. And as I stated before, every thrift depositor can rest assured that the Federal Government stands fully behind the FSLIC fund, and that no insured deposits are at risk.

At the same time, however, we cannot afford to lose sight of just how serious the thrift problem is. While there are widely varying estimates of just how much it will cost of close out the insolvent institutions, there is little doubt that FSLIC resources will need to be augmented. While it is clear that further assistance will not be required this year, Congress must continue to watch the situation very closely, in order to ensure that when further action is required, it occurs in as timely and cost-efficient a manner as is possible.

STATEMENT OF SENATOR JIM SASSER

Senator SASSER. Mr. Chairman, I am pleased that the committee is continuing its investigation into the condition of the Federal Savings and Loan Insurance Corporation. Last week's hearing was an eye opener for most of us. The range of the estimates of the cost of resolving FSLIC's problems is disturbing, particularly when the sceptor of a "taxpayer bailout" is raised.

However, I believe that Chairman WALL is making great progress in dealing with a mammoth problem. By all reports the performance of the Bank Board has markedly improved during his tenure. Indeed, I am looking forward to his testimony today.

Mr. CHAIRMAN. I do believe that the Bank Board's projections are overly optimistic. The GAO study makes this point quite clearly. If the situation is getting worse every day, Congress should consider action this year.

I am especially disturbed that much of the deterioration of the thrifts can be traced to deregulation in the early and mid-1980's. It appears that certain States permitted State-chartered savings and loans to move aggressively into new areas. And there was little or no supervision from the insurer of the deposits—the FSLIC.

Thank you, Mr. Chairman.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Today we return to the condition of the thirft industry and what's being done to solve its problems. I certainly hope that in the discussion today, unlike our last hearing, we resist throwing around numbers that are completely speculative.

We can argue from here until Sunday about the ultimate size of the FSLIC problem, particularly in the out years. But there are certain facts that we should keep in mind. After more than 2 years of prodding, Congress finally passed a FSLIC recap plan 10 months ago. That plan is now up and running: FSLIC has received its first infusion of funds; supervisory resources have been beefed up; and a clear plan has been adopted for moving forward, particularly in the Southwest. Virtually everyone agrees, including last week's witnesses, that the most important thing to be done is to move ahead and resolve the problem cases that are known, which everyone also agrees will take several years. The testimony today shows that the Bank Board has begun to do just that. It is also clear that it will be some time before we know just how large the problem actually is.

As a result, there is simply not much more we can do in the short term. The FSLIC needs to clean up the worst part of the problem as quickly as possible with the resources that Congress has given it. It has only begun to use these resources and could not do anything more now even if it received more. We need to stop speculating now about the size of problems several years down the road and concentrate instead on resolving the problems we know about. Then we can argue about the size of the problem and whether any new funds are needed.

I want to make one more point. I understand there were charges yesterday that the administration has been insensitive to this problem and simply wants to throw up its hands. Let me remind these critics that the administration proposed and lobbied hard for a $15 billion plan to recapitalize FSLIC 2 years ago. That plan did not involve a dime of taxpayers' funds. Congress finally acted on the proposal a year later, but specifically refused to provide the full $15 billion because of arguments that the problem was not nearly that large. In fact, this committee rejected not only the proposal to provide $15 billion, but also a proposal to provide $10 billion—it was only in the conference at the insistence of the administration that the number was raised to $10 billion to avoid a veto.

So don't blame the administration for not trying to resolve this problem. If the full $15 billion had been provided in 1986 we might not be here now. If you want to point fingers, point them at the Members of Congress who sought to delay and reduce the original FSLIC recap plan.

STATEMENT OF SENATOR ALFONSE D'AMATO

Senator D'AMATO. Mr. Chairman, I would first like to welcome Danny Wall, Chairman of the Federal Home Loan Bank Board, back to these familiar precincts. Danny, all of us here know that you did a great job while Republican staff director for the committee, and in my view have, since assuming you new duties, performed admirably in the most challenging and difficult circumstances. It's kind of like being made captain of the ship just when it's being carried toward the rocks.

This hearing is a second step in a two step exercise that began a week ago when a panel of experts appeared before this committee to opine on the soundness of FSLIC. Last year when we marked up and passed the Competitive Equality in Banking Act, including a FSLIC recapitalization plan, most of us knew, Mr. Chairman, that FSLIC was going to have a challenging time trying to handle its responsibilities within the limits of the funds we were then making available. The House-Senate conference on CEBA further whittled down that recapitalization.

Not surprisingly, the year that has passed since has brought ever more spectacular and dangerous failures and near failures in the thirft industry, potentially affecting hundreds of thousands of depositors and imperiling the soundness of our financial industry.

Under these circumstances you have done, I think, a commendable job, attacking the problems of the thrift industry with optimism, initiative and vigor. A particular example is the Board's so-called "Southwest" plan targetted at a region where the industry's problems have been especially acute. Earlier this month we saw the merger of four thrifts with Southwest Savings Association in the largest such deal yet arranged. The day before yesterday brought the chartering of a new Federal S&L to acquire the assets of a failing thrift in Scottsdale, AZ. These are hopeful developments demonstrating that with the commitment of expertise and an aggressive approach, solutions can be found that minimize Federal insurance participation.

Despite these efforts, however, no one here—least of all you, I suspect—believes these problems are going to go away.

Last week's testimony by Mr. Wolf—of the GAO—strongly suggested that current FSLIC funding is inadequate. Although almost ⅔ of the S&L industry was profitable in 1987, earning $6.6 billion, these profits were far outweighed by the $13.4 billion loss experienced by the other third.

More alarmingly, at the end of 1987, over 500 insolvent institutions with a combined negative net worth estimated at $18 billion were still operating.

According to the GAO report, FSLIC had a 1987 operating loss of $8.6 billion, leaving it with a $13.7 billion deficit—double that of the year before. More to the point, FSLIC's financial statements reflect a liability of more than $17 billion for the more than 200 insolvent thrifts for which FSLIC already has asumed responsibility. Obviously, no one doubts that that "caseload" will only grow. Some of these cases will not be resolved for years.

Let me emphasize, Mr. Chairman, that that liability is not a "projected" loss. Instead, it is the cost to resolve currently assumed obligations. The extent of FSLIC's further exposure can be guessed at in light of the fact that, as of the end of last year, almost 300 additional institutions—assets: $88 billion—were insolvent.

There is a long way, Mr. Chairman, to any light at the end of that tunnel.

I remain unconvinced that a taxpayer bailout of the thrift industry is necessary or appropriate; I am impressed with what Chairman Wall and his troops are doing with what they've got, and I'd like to give them room to work.

Nevertheless, it was the unanimous conclusion of the panel last week that a bailout would be necessary. I'd like to know what you think, Mr. Wall, about these estimates. If we will have to do more, tell us; the time to bite the fiscal bullet is now. If a major, further infusion of funds is necessary to manage this industry's problems, we should face it sooner rather than later. This is no time for political shadowboxing.

I have confidence, Mr. Wall, not only in your competence, but your candor and I look forward to your testimony.

Thank you.

STATEMENT OF SENATOR JOHN H. CHAFEE

Senator CHAFEE. Mr. Chairman, I commend you for holding this hearing to review the current status and prospects of the thrift industry.

The thrift industry was initially chartered to offer a repository for savings which could then be funneled into residential mortgage lending. This approach serves the Nation well, when the goal of every family is to own its own home.

Interest-rate risk—the mismatch of lending long and borrowing short when the yield curve inverts—has been able to be largely contained. This has been due to the elimination of interest rate ceilings on deposits, the growth of adjustable rate mortgages—ARM's—and the impact of securitization, allowing thrifts to reduce the time mortgage loans are held on their books.

Unfortunately, asset quality risk has worsened. Several thrifts thought higher rates of return could be achieved in areas like commercial lending and real estate development. Accordingly, the focus of thrift activity has increasingly shifted toward nonmortgage activity.

The combination of regional recession, imprudent lending practices that often may have bordered on fraud, and inadequate regulatory supervision have led to the difficulties FSLIC now faces. Estimates to resolve the problems of GAAP-insolvent thrifts range from $20 billion to over $60 billion. The precise number is unquantifiable, but the critical question is whether FSLIC will have enough funds to make good the promise of government deposit insurance from its available sources and, if not, who makes up the shortfall.

But before we decide on the merits of any specific action regarding FSLIC, it would be well to consider three issues.

First, do thrifts still serve a particular societal purpose? In return for mortgage lending, thrifts receive long-term, low-rate advances from Federal Home Loan Banks for any use, broad activity choice—such as insurance and real estate—beneficial tax treatment, and wide geographic expansion authority. Yet it is difficult to tell whether the basic thrust of thrifts is to remain principally mortgage lenders or to move toward full purpose financial services, of which mortgage lending is only a part. Chairman Wall's testimony indicates: "Holdings of home mortgages and mortgage-related, pass-through securities investments declined from 71 percent—of assets—at the end of 1980 to 53 percent in 1987". Is the age of thrifts as chiefly mortgage lenders over?

The second matter is the maintenance of safety and soundness. In the Proxmire bill with regard to bank securities activities, we responded to this through the creation of a separate securities affiliate, additional firewall protection, and greater regulatory supervision. Perhaps certain more speculative thrift activities should be handled in a similar fashion.

The third issue is the need for increasingly coordinated regulation in the financial services industry. Just as the Brady Commission has spoken of a single market for equity and equity-derivative products, so the deposit taking and mortgage lending markets have multiple providers but a single goal.

It is in the context of these issues that we should review the performance and future prospects of FSLIC. Whether the $10 billion—net—of recapitalization bonds to be issued will be sufficient. how quickly to close problem thrifts, how to reduce the deposit premium that insolvent thrifts are paying and causing other depository institutions to pay, what to do about FADA—all of these questions must be dealt with. But we should first decide the overarching approach.

I look forward to the testimony of the witnesses.

STATEMENT OF SENATOR DAVID KARNES

Senator KARNES. Mr. Chairman, this morning the committee will have the opportunity to hear testimony on the current condition of the thrift industry. On several occasions, I have stated my particular interest in this area. I appreciate your efforts and those of Senator Garn, the ranking minority member of the committee, in continuing to apprise the members of this committee on the current conditions of the thrift industry. I look forward to the testimony of Chairman Wall and the opportunity for members of the committee to hear his perspective on the current condition of the industry.

Mr. Chairman, as I have stated on numerous occasions, I have a long standing commitment to the savings and loan industry. I believe that we must take steps now that will serve to attract private equity to the thrift industry. Of equal importance, we must also encourage those currently invested in the industry to maintain their substantial capital positions and avoid penalizing the viable, profitable institutions that are now carrying a larger burden than ever. The attraction of new capital to the industry is necessary if we are to minimize the potential call upon the resources of the FSLIC to support the deposits of those savings and loan institutions which are experiencing financial difficulties. The acquisition of troubled thrift institutions will relieve the FSLIC of both the financial and the management burdens which it has found increasingly difficult to manage. The most likely investors in troubled thrifts are healthy thrift holding companies who see resulting business opportunities in such transactions. We must be realistic and recognize that acquisitions of troubled thrifts will take place only where adequate incentives exist.

Earlier this year, I introduced S. 2073, the Thrift Charter Enhancement Act of 1988, with Senators Bond and Cranston as cosponsors. The purpose of the bill is to attract capital to the thrift industry by making thrift charters more attractive and encouraging the acquisition of ailing thrifts. This committee held a hearing on S. 2073 on April 27. I believe that it is fair to say that the reaction to the bill has been very positive. I believe serious consideration should be given to this legislation at this time when attracting new capital to the thrift industry will reduce the pressures on FSLIC.

As several of the panelists have stated over the past number of hearings, procrastination and delay will only exacerbate the problems and increase the ultimate losses. I suggest the time has arrived to focus on those provisions of S. 2073 that have the most promise for attracting capital to the thrift industry and for encouraging the movement of troubled thrifts out of the FSLIC into private hands that have the expertise to manage them. I see no reason for further delay in identifying those provisions and moving the bill toward enactment this year.

The Federal Home Loan Bank Board has acted to limit S&L's and FSLIC's exposure to certain investments and loans. The Bank Board has increased the supervisory and examination staff and has adopted regulations to limit certain highly risky loans, increase capital requirements, and require S&L's to begin reporting in accordance with generally accepted accounting principles. My point is that we should not lose sight of the fact that significant accomplishment has been made and I compliment Chairman Wall for those efforts. However, as all of us acknowledge, the problems and thus the challenge is great. I look forward to your testimony.

Senator RIEGLE. Mr. Wall, we would be pleased to hear from you now.

STATEMENT OF M. DANNY WALL, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD

Mr. WALL. Thank you, Mr. Chairman, and members of the committee, it is a pleasure to be here today and I look forward to our exchange and the opportunity to respond to what I'm sure are well-prepared questions, knowing the staff of this committee.

The supervision of the Federal Home Loan Bank Board has been strengthened. I want to begin with that, and I will then proceed through the various sectors of the agency in response to the call from the committee to discuss the condition of the industry and the condition of the agency. In each case I will identify goals and future projections as far as each of these sectors is concerned.

We have an extensive prepared testimony and I would ask that it be incorporated in the record.

Senator RIEGLE. Without objection.

Mr. WALL. I will proceed if I may with a few minutes of oral remarks, some reflecting on the prepared text, and indeed, some expanding thereon.

INADEQUATE SUPERVISION

A major focus of the Bank Board has been the strengthening of the supervisory function. As I noted in my written statement, in the early 1980's the thrift industry came under tremendous earnings pressure due to the high and volatile interest rates and the removal of reg. Q.

When the Congress moved to strengthen thrifts by expanding their powers, the Board's supervisory function, both in terms of numbers and experience of staff as well as policies and procedures, was, quite frankly, inadequate. In some districts it was more inadequate than in others to deal with the challenge posed by weak or dishonest thrift managements struggling with poorly capitalized or even insolvent institutions.

The result was that a minority of thrifts took significant risks either through fraudulent underwriting or offering loans for large interest rates. This deficiency in our supervision of the industry has been recognized and is well on its way to being corrected.

Action to solve the staffing problem was initiated in June 1985. On a systemwide basis, the examination and supervision function has been strengthened by a doubling of the professional staff. Recognizing the importance of moving quickly, emphasis has been placed on filling senior vacancies with experienced staff from other Federal and State banking agencies. A number of staff positions have been filled with examiners and senior analysts from the Federal Reserve Board, the FDIC, the Office of the Comptroller of the Currency, the OMB, and the big eight accounting firms.

The supervisory function now includes the former Head of Bank Supervision of the Federal Reserve Board, the former Chief National Bank Examiner, the Assistant Chief National Bank Examiner, three Deputy Comptrollers of the Currency, the former Head of Consumer Examination at the Federal Reserve Board, and senior staff, including commissioners from the State regulatory agencies.

Where weaknesses have been identified, personnel changes have been made. I sincerely believe that the Bank Board's present supervision and examination staff is stronger than it has ever been in the history of the Bank Board and at least the equal of the other regulatory agencies.

Another area of weakness has been the system's supervisory and examination policies and procedures. Without going into an explanation as to why this happened, let it suffice to say that we recognize the problem and are addressing it. The need for both better policies and more consistency in their implementation is being addressed by the heads of supervision of the District Banks and/or through a number of task forces.

For the first time, supervisory staff in the 12 District Banks are working together as a team to address the critical issues facing the system. A comprehensive overhaul of the bank supervisory and examination policies and procedures is underway by a series of task forces staffed by Washington and district staff.

By year end, a multivolume regulatory handbook will have been produced which, for the first time, sets forth systemwide policies on examination procedure. Much of this has been made necessary by the fact that we now have a multidistrict structure of many institutions, where, for example, institutions are located in district A and have branches and/or operations in more than one other district. It is necessary and desirable that we work toward uniformity by and between the district for the sale of multidistrict companies and those in competition with multidistrict companies.

To ensure that the supervisory function remains strong at the district level, a quality control program has been initiated at each District Bank. A peer review program is now in place to conduct in-depth analyses of the examination and supervisory functions at each Bank. To date, peer reviews of five Banks have been completed, two more are in progress, and another two will be completed before the end of the year. Thus, from July 1 of last year through the end of this year, an 18-month period, we will have conducted peer reviews in 9 of the 12 District Banks.

This program is supplemented by quarterly meetings between Washington and district supervisory staff to review each Bank's supervisory strategies and progress toward meetings its goals. This is just one more example of this Board's effort to ensure the proper supervision of the thrift industry.

As far as the Bank system itself is concerned, there are of course 12 district banks around the country. They have within them \$154.1 billion in assets. Last year they made \$1.3 billion in profit and paid \$1.32 billion in dividends. With an aggregate capital ratio of 8.9 percent, they are probably the strongest capitalized financial institutions in this country and, of course, collectively are the second largest financial institution in the country.

We are providing through the Bank system expanded services and credit enhancement programs of various types so as to provide the industry with the tools and instruments with which to protect themselves properly and/or to anticipate shifts in interest rate. We are doing this through some changes and enhancements with regard to the types of instruments available from the District Banks: letters of credit programs; convertible advances; lines of credit; revolving credit programs; and adjustable advances just to name a few.

As far as the industry is concerned, there are within the industry 3,150 institutions. They have within their walls $1.25 trillion in assets, $900 billion in deposits in 100 million accounts. Something that this committee, of course, has been spending a good deal of time on over the last several years and increasingly in the last few months, is the question of this emerging financial services industry and the changes that are occurring. This industry, because of those 100 million accounts, as well as the laws that have permitted the branching and interstate existence—presence, if you please, of thrifts puts this industry in the best place, in the best position, to be the financial service provider to the average American family.

They have as well within their portfolios $690 billion worth of mortgages and mortgage-backed securities which represent 40 percent of all the residential mortgage debt in this country.

MORTGAGES

In 1987, the thrift industry originated 40 percent of all of the mortgage loans that were originated in this country. These originations came at a time when the market share war for mortgage originations was underway in unprecedented proportions, when a company like General Motors came from not having been in the mortgage banking business to being No. 1; and a company like Citicorp went from having widespread pieces in its mortgage banking business to operating the second largest mortgage origination activity in the country.

Nevertheless, in a year when that kind of market share war was underway, the thrift industry continued to orginate no less than 40 percent of all the mortgages that were originated.

Housing finance has always been discussed and recognized under the "loan" aspect of a savings and loan's business as an important part of the industry's function and purpose. Clearly that has had Congress' support and has been the reason for various pieces of legislation down through the years.

I think that we should be spending more time in dealing with the savings side of the savings and loan industry because clearly the industry has provided a safe, secure and productive place for the deposits of the American family and will continue to do so.

As far as deposit growth, we have seen incredible deposit growth over the last period of time. The month of October of last year saw the largest single monthly net new deposit growth in the history of the industry—$6.2 billion flowed into the thrift industry. Some would say that the influx came as a result of the October 19 crisis. There were only 11 days left in October after the 19th and that inflow had begun before the crash on the 19th, so as to cause the whole month to have reached a record level. Either there were a lot of people who were much wiser than the gurus on Wall Street, and who could see what was coming and therefore took their money out of something else, perhaps the street, and put it into the savings institutions or indeed we had already begun to see a return of confidence in the thrift industry on the part of the depositors in this country. This renewed confidence was due, in no small part to the fact that 2 months earlier Congress had provided the recapitalization authority that had been so long sought.

During the 6 months from October 1987 to March 1988 we have seen $27.3 billion of net new funds flow into the thrift industry—$4.5 billion on monthly basis. In the first quarter of 1988 we saw a $15.2 billion inflow of net new deposits. That's the largest quarterly inflow since the fourth quarter of 1984.

As far as goals for the industry, we intend to preserve and further enhance depositor confidence. We are also proposing an increased CRA allocation for service corporation activities in the thrift industry. We would also propose to continue to support congressional activities to enhance and modernize further the Federal charter.

As far as the Federal Savings and Loan Insurance Corporation, FSLIC, is concerned, since I became the Chairman on the first of July of last year, we have resolved 52 cases with assistance. We have resolved 5 cases at no cost to FSLIC. In that not quite 10-month period we have dealt with 57 institutions and that, of course, is not including this week, which I will discuss later.

THE SOUTHWEST PLAN

Apropos of the arrival of Senator Gramm, would like to discuss the Southwest Plan. In the last 2 weeks we have dealt with 8 troubled institutions in the State of Texas merging them into two healthy institutions. A fact that has been overlooked in the reporting of these announcements is that those 10 institutions, now 2 surviving institutions, contain 7 percent of all the deposits in savings and loans in the State of Texas. Not only have we begun reconfiguration under the Southwest Plan, we have begun it with quite a burst of activity having dealt with 7 percent of all the deposits in the State.

We will be announcing early next week in a State other than Texas the purchase of a troubled institution in excess of $1½ billion and the group that will be buying that institution will be putting $100 million of new equity into the institution. FSLIC will receive up to $50 million in preferred stock in that institution. We will have to wait until all the paperwork has been completed in the first part of next week to provide the other information on that institution, but it is one that has been on the list of troubled institutions for no less than 3 years and it is one that we are pleased to get resolved, and especially with that degree of new capital being brought to the table.

As far as our goals for FSLIC, we intend to complete the reconfiguration of the Texas institutions by the year end. We intend to complete all of the contract actions for the 109 insolvent Texas institutions by June of next year, a year from now. We intend and expect to complete the first group of cases that were talked about by GAO earlier last week—the 259 so-called FSLIC cases—by year end of 1989.

We intend to complete the balance of the 511 currently GAAP insolvent institutions by the end of 1992. That would involve the second so-called tranche of 252 institutions. In so doing we expect to bring more capital, both human and financial, to the thrift industry.

I would like to turn to the General Accounting Office ['GAO'] and their report to this committee last week. GAO is our agency's public accounting firm. It has the responsibility to provide our certified public audit. We agree with the GAO on a number of aspects, or they agree with us, whichever way you care to look at it, and much of this has been overlooked in the reporting and in the commentary that has followed last Thursday's hearing.

As an example, we agree on the amount to be provided under the term "allowance for unresolved cases"—$17.4 billion. That amount would be for that first group of 259 identified cases to be resolved. We both agree that a FSLIC note is an asset. We also agree again that the resources expected to be available in a conservative view would be $20 billion over the next 3 years. GAO made the observation about our assumptions that they were relatively optimistic but not unreasonable.

Whle we don't agree on some aspects of what they reported, I'd like to point out that our disagreements are not gigantic. As far as the resources available over 10 years, GAO's estimate was $28 billion; our estimate is $30.2 billion—not a huge amount of difference.

As far as the second group of insolvent institutions are concerned, 252, we identify an estimate for resolution of $5.3 billion. FSLIC resolution of these cases, of course, would be a little further off in time, and is not probable, but rather possible, under the terminology of the accounting profession. GAO says that the cost of the resolution of those 252 institutions could be from $9 to $19 billion. The bottom line is, even if GAO is correct, that the size of the problem would be $26.4 to $36.4 billion. The resources that GAO agrees that we will have available over 10 years, $28 billion, or our estimate of $30.2 billion, are clearly within the range of the size of the problem as GAO sees it.

No one has said that all of the authority that was provided by the Congress last summer and signed in law by the President on August 10 was going to be enough. Congress said that rather than approving $15 billion of borrowing authority, it would give us basically $11 billion of borrowing authority and the time to proceed to utilize those resources to see how much of the problem we could resolve and how much recovery would have taken place in the microeconomies that we deal with. And that is clearly what we are doing.

It is appropriate, as indeed the Congress has done, to have the GAO make the assessment and we would expect that kind of assessment to continue to be made. We will participate in the process. When the legislation was signed into law last year, the Congress and the President at the time said that the next Congress and the new President would assess what we will have been able to do with those resources and how much of the problem remains. In the interim, we will continue to update and review the estimates on the basis of the agreed upon methodology for estimating the cost of case resolution. By that, I mean the methodology that we and the GAO have come to agree on. The GAO assessment of the cost of what was then called "contingent liability" in 1985 and in 1986, was not based on a scientific methodology, but rather based on nothing more than rough estimates of what the size of the problem then lying before them.

We will continue to provide the reports as required under CEBA and then some as far as being responsive to the Congress as to the status as we proceed. Let me then, if I might, call on the staff to provide a copy of the cash flow that we would like to review for a couple of minutes. We have a two-page document that we would like to make available to you. We will review, I think, for the first time something that's never been provided by this agency, and I'm not sure by other agencies—a cash flow projection for our agency for a 10-year period.

[Document submitted for the record follows:]

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
PRO FORMA: ESTIMATED BUDGET OUTLAYS AND CASH FLOWS
FISCAL YEARS 1988 - 1997
($ thousands)

Assumptions:
Full special assessment continued until
FSLIC notes payable paid off in 1995
Deposit growth @ 1.75% per quarter
Potential return on Southwest plan
assistance is not shown

pg. 1 of 2

		PROJECTED FY 1988	PROJECTED FY 1989	PROJECTED FY 1990	PROJECTED FY 1991	PROJECTED FY 1992	subtotal (1988-1992)
1	RECAPITALIZATION PROCEEDS	3,050,000	2,000,000	1,500,000	1,000,000	1,000,000	8,550,000
2	REGULAR INSURANCE PREMIUMS	585,609	428,206	322,091	270,042	241,345	1,847,294
3	SPECIAL INSURANCE PREMIUMS	1,032,053	1,151,002	1,269,541	1,389,432	1,512,206	6,354,234
4	INTEREST ON SECURITIES	134,210	222,974	182,328	108,376	79,239	727,127
5	RETURN ON CLAIMS AGAINST RECEIVERS	1,745,633	1,040,659	1,036,872	1,032,379	1,028,215	5,883,758
6	CAPITAL CERTIFICATE INCOME	44,000	44,000	44,000	44,000	44,000	220,000
7	LIQUIDATION OF ACQUIRED ASSETS	37,152	39,311	41,192	42,830	44,257	204,743
8	MISCELLANEOUS INCOME	193,869	198,966	202,161	184,702	154,382	934,081
9	ADMINISTRATIVE AND NONADMINISTRATIVE OPERATING EXPENSES	(169,484)	(179,619)	(188,284)	(198,789)	(214,314)	(950,490)
10	ASSETS ACQUIRED FROM INSURED INSTITUTIONS	(53,891)	(53,891)	(53,891)	(53,891)	(53,891)	(269,455)
11	INTEREST ON NOTES PAYABLE	(479,024)	(743,556)	(763,842)	(753,367)	(756,801)	(3,496,590)
12	PRINCIPAL PAYMENTS ON NOTES ISSUED BEFORE 1987 *	(341,777)	(239,912)	(179,934)	(134,951)	(116,213)	(1,012,786)
13	NEW NOTES PAYABLE *	(6,267,000)	(3,478,000)	(1,749,000)	(1,754,000)	(1,183,000)	(14,431,000)
14	ASSISTED SOLUTIONS	(1,079,000)	(1,399,000)	(1,917,000)	(1,988,000)	(1,171,000)	(7,554,000)
15	INSURANCE SETTLEMENTS	(2,000,000)	(500,000)	(500,000)	(500,000)	(500,000)	(4,000,000)
16	Net Budgetary Inlay (Outlay)	(3,567,649)	(1,468,859)	(753,765)	(1,311,236)	108,425	(6,993,085)
17	PRINCIPAL PAYMENTS ON NOTES ISSUED AFTER 1986 *	400,000	2,150,000	2,150,000	1,300,000	1,300,000	7,300,000
18	OUTSTANDING NOTES PAYABLE	8,750,410	9,838,498	9,257,564	9,576,614	9,343,401	
19	Cash Inflow (Outflow) **	2,299,351	(140,859)	(1,154,765)	(857,236)	(8,575)	137,915
20	End-Of-Year Investments	3,199,197	3,058,337	1,903,572	1,046,336	1,037,761	

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* Current budget guidelines require FSLIC to count the full principal value of all promissory notes issued after FY 1986 as budgetary outlays. Accordingly, principal payments on these notes are excluded as budgetary outlays. Also, only principal payments on notes issued before 1987 are counted as outlays.

** Cash Inflow (Outflow) equals Net Budgetary Inlays (Outlays) minus New Notes Payable minus Principal Payments on Notes Issued After 1986.

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
PRO FORMA: ESTIMATED BUDGET OUTLAYS AND CASH FLOWS
FISCAL YEARS 1988 - 1997
($ thousands)

Assumptions:
Full special assessment continued until
FSLIC notes payable paid off in 1995
Deposit growth @ 1.75% per quarter
Potential return on Southwest plan
assistance is not shown

	PROJECTED FY 1993	PROJECTED FY 1994	PROJECTED FY 1995	PROJECTED FY 1996	PROJECTED FY 1997	TOTAL (1988-1997)
1 RECAPITALIZATION PROCEEDS	1,000,000	1,000,000	275,000	0	0	10,825,000
2 REGULAR INSURANCE PREMIUMS	217,721	199,536	221,934	315,125	415,012	3,216,622
3 SPECIAL INSURANCE PREMIUMS	1,423,286	1,814,870	1,945,285	0	0	11,537,675
4 INTEREST ON SECURITIES	78,275	77,441	68,615	72,634	108,759	1,132,849
5 RETURN ON CLAIMS AGAINST RECEIVERS	951,870	860,000	400,000	50,000	50,000	8,195,628
6 CAPITAL CERTIFICATE INCOME	44,000	44,000	44,000	44,000	44,000	440,000
7 LIQUIDATION OF ACQUIRED ASSETS	45,500	46,582	47,525	48,346	49,062	441,758
8 MISCELLANEOUS INCOME	161,438	168,720	176,254	184,068	194,025	1,818,586
9 ADMINISTRATIVE AND NONADMINISTRATIVE OPERATING EXPENSES	(214,314)	(214,314)	(214,314)	(214,314)	(214,314)	(2,022,060)
10 ASSETS ACQUIRED FROM INSURED INSTITUTIONS	0	0	0	0	0	(269,455)
11 INTEREST ON NOTES PAYABLE	(630,467)	(373,672)	(116,941)	0	0	(4,617,671)
12 PRINCIPAL PAYMENTS ON NOTES ISSUED BEFORE 1987 *	(725,120)	(694,756)	(694,756)	0	0	(3,127,417)
13 NEW NOTES PAYABLE *	0	0	0	0	0	(14,431,000)
14 ASSISTED SOLUTIONS	(100,000)	(100,000)	(100,000)	(100,000)	(100,000)	(8,054,000)
15 INSURANCE SETTLEMENTS	0	0	0	0	0	(4,000,000)
16 Net Budgetary Inlay (Outlay)	2,252,190	2,828,406	2,052,602	399,858	546,545	1,086,516
17 PRINCIPAL PAYMENTS ON NOTES ISSUED AFTER 1986 *	2,200,000	2,800,000	2,228,770	0	0	14,528,770
18 OUTSTANDING NOTES PAYABLE	6,418,281	2,923,526	0	0	0	
19 Net Cash Inlay (Outlay)	52,190	28,406	(176,168)	399,858	546,545	988,746
20 Investments (end of period)	1,089,951	1,118,357	942,189	1,342,047	1,888,592	

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* Current budget guidelines require FSLIC to count the full principal value of all promissory notes issued after FY 1986 as budgetary outlays. Accordingly, principal payments on these notes are excluded as budgetary outlays. Also, only principal payments on notes issued before 1987 are counted as outlays.

** Cash Inflow (Outflow) equals Net Budgetary Inlays (Outlays) minus New Notes Payable minus Principal Payments on Notes Issued After 1986.

CASH FLOW PROJECTIONS FOR FSLIC

It is such a cash flow that the GAO referenced last week, when Mr. Wolf responded to a question from, I believe, Senator Garn with regard to the appropriateness of treating an FSLIC note as an asset.

Clearly you will want to spend a good deal of time looking at these two pages. There is an incredible amount of information there, as an incredible amount of work has gone into these pages.

Let me quickly sort of summarize if I might what these cash flow documents provide. They show that we have projected resources over 10 years of $30.2 billion. As you look at lines 9 through 15, recognize that some of those costs have been incurred already so they cannot really be identified as resources as being available for future case resolution. Thus, the bottom line of lines 9 through 15 in terms of net available, or net to be applied in the future toward solving problems, is the $30.2 billion.

Lines 1 through 8 show the total of $37.6 billion of resources and, of course, the difference is the amount of resources that already have commitments against them. If you look at line 18 you see a line indicating outstanding notes payable and on the second page under the column for 1995 you will see that shows as a zero. What that means is we propose to utilize FSLIC notes to carry out these activities more quickly and more cost effectively rather than borrowing from FICA or from the bonding program as quickly as Congress otherwise had permitted us to do.

We would propose to utilize the FSLIC notes up to a high point next year of $9.8 billion of existing issued FSLIC notes, which is clearly within our resources, not extending beyond the resources available or to be available to retire those notes. The cash flow shows that we would retire those notes by the year 1995 and, depending upon the cash situation, perhaps even by 1994.

The projection is also that the special assessment would terminate in 1995 with the payment of the final FSLIC note that would have been issued. We would also have reached the full borrowing authority of FICA in 1995.

Now our assumptions, which the GAO analyzed as perhaps optimistic but not unreasonable, are that deposits will grow at 1.75 percent per quarter or 7 percent per year. That is not an unreasonable deposit growth projection. Since 1964 you have to try very hard, in fact it's almost impossible to find a 10-year period where that kind of average rate of growth has not existed. You even have to try very hard to find a 5-year period in which a 7-percent rate of deposit growth has not occurred.

Under the assumptions, the special assessment would be terminated totally in 1995 or when the FSLIC notes were paid off. We also identify as part of our assumptions that the current tax treatment of FSLIC as being tax exempt would be extended. We are not including in our cash projections the "up side." For example, we are not showing any up side from the sale or the improvement in the sale of the assets that we take into our responsibility or that we leave in institutions such as those under the Southwest Plan. Thus, there is no up side of any improvement in the asset value. There is also no up side shown in these cash flows for the income that we would get either on a profit sharing basis or on the ownership of stock in the institutions we recast and there is no up side for the tax benefits, the NOL's and other tax benefits in which FSLIC shares as agreed to under each contract.

The cash flow reviews will be maintained and provided to you on an ongoing basis. Again, this kind of protection—for a 10-year period—that has never been done by this agency and I'm not sure the extent to which it's been done to this detail by any agency with the kind of responsibilities that we have.

Now as I reach the conclusion, let me talk about a couple of miscellaneous items that clearly are very important and very significant to everyone. I would like to mention the August 10 expiration of the moratorium that now prohibits the switching from an FSLIC to an FDIC insurance status of a thrift institution. In response to a question put to us by the chairman of the House Banking Committee last evening, we, the Board, responded that we recommended an extension of that moratorium of 12 months, recognizing that we're nearing the end of a congressional session and that we're nearing the election which includes a Presidential election. We will be transitioning into a new administration next year. It is a matter of, we think, logic and realism to propose that there be an extension of that moratorium.

There are, however, other ways of dealing with the problem. We don't think the expiration of the moratorium presents an economic problem. It is a problem, we believe, of perception and the concern that the perception might come to be a reality, but we don't see it as being reality; we see it as a concern for the perception.

There really are three alternative ways to address the moratorium question. First, there could be an increase in the exit fee so as to provide the economic offset for the departure of an institution from FSLIC to FDIC insurance. There could, in the alternative, be the provision of law that would require or that would provide that any institution making such a conversion would be considered as if it were a multiple S&L holding company, that is, be limited to what a bank or a bank holding company could do in terms of activities. Another possibility is to make even more explicit than is we believe the case currently our authority to provide for a variable rate premium structure as far as the healthier institutions. Our having the ability to assess a lower premium on the healthier institutions is a question that we currently have out for comment and the comment period will end the first week in June. When we went for comment, the Board asked the question as to whether or not there were views that we had the legal authority to do so. It's not clear that we have the legal authority to provide for a risk-based premium structure. It is the kind of thing to which Congress has given a lot of attention to in a policy sense but for which it has not provided explicit legislative authority.

With regard to the special assessment question we must, every quarter make the finding as to whether circumstances such as the moratorium or other pressures around other aspects of the structure of the industry and the insurance structure need for those resources. It seems to me a possible approach to providing for a ratcheting down of the special assessment, perhaps at a rate slower than is provided for in the current legislative instruction from the

Congress, would be for us to reflect on the experience we would have had vis-a-vis the assumptions that we have put forward in our cash flow. For example, if the deposit flows were to be greater than had been provided for; or if other aspects of our cash flow and our assumptions would have been proven to have been underestimated we could provide for a return of part of that special assessment, that might be a way of approaching the special assessment formula.

Finally, with regard to the matters as they are posing themselves to the Congress, to the President, to the agency and to the industry—all must consider and evaluate the demands being placed on the industry to expand its capital, institution for institution, while at the same time recovering a number of those institutions from difficulties, whether by merger or the infusion of new capital from outside, and also paying the interest on the FICO borrowing. There is a point at which the industry will not be able to achieve all of those requirements, and it is something that the Congress, as I say, the President, the agency and the industry are going to have to spend more time talking about.

There is another issue, as well, that Chairman Riegle has discussed earlier, both in a private meeting I had last week, as well as publicly at the hearing with the GAO last week, and that others have talked about. Senator Sanford raised it in this hearing room at my confirmation hearing. Senator Graham of Florida raised it the last time it was before this committee, and that is the conflict between the Federal deposit insurance system on the one hand and the State chartering authority on the other hand. It is clearly, under the concern and under the umbrella of the term of reference of States' rights, an issue that is out there and that is raising itself again.

These are not new questions, but as so often is the case under pressure, they come into clearer focus. I look forward to responding to your questions.

[The complete prepared statement of Mr. Wall follows:]

STATEMENT OF
M. DANNY WALL, CHAIRMAN
FEDERAL HOME LOAN BANK BOARD
BEFORE THE
COMMITTEE ON BANKING, HOUSING AND
URBAN AFFAIRS
U. S. SENATE

MAY 26, 1988

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Mr. Chairman and members of the Committee, I am pleased to appear before you today to discuss the current condition of the thrift industry. Although this is not my first appearance before this Committee, it is my first opportunity to comprehensively report to you about what I have been learning and what has been occurring since my appointment to the Federal Home Loan Bank Board ("Bank Board") nearly 10 months ago. I especially welcome this chance to lay to rest certain speculation regarding the industry and to present you with an up-to-date picture of its financial condition and long-term viability.

As you are well aware, the financial services industry is undergoing unprecedented change as traditional barriers to interstate operations are crumbling and as capital markets are becoming more integrated and internationalized. All participants in the industry are currently adjusting to a climate characterized by volatile interest rates, regional economic weaknesses and a record number of failures. I would emphasize, however, that despite these conditions, the vast majority of the thrift institutions insured by the Federal Savings and Loan Insurance Corporation ("FSLIC") are profitable and solvent. As the financial services industry continues to evolve, I believe well-managed and adequately capitalized thrifts will continue to play an important role.

I. THE FINANCIAL CONDITION OF THE THRIFT INDUSTRY

Before I discuss the current state of the industry in some detail, I would like to provide you with an historical perspective of today's problems. Ever since its development more than 150 years ago, the thrift industry has concentrated on providing a safe and secure place for savings, which in turn have been primarily used to fund home purchases. For years, its asset powers were primarily restricted to housing-related investments and its liabilities were generally limited to savings. Thrifts, like other insured financial institutions, were limited by regulation with regard to the interest rates they could pay on their deposits.

The protection offered by the ceilings on interest rates on deposits was eliminated during the early 1980's at a time when interest rates had risen to unexpectedly high levels. The thrift industry was suddenly forced to pay unprecedented rates on its deposits while earning relatively low rates on its primary assets -- long-term, fixed rate mortgages. The effect of high interest rates coupled with interest rate deregulation was the collapse in profits at hundreds of thrift institutions. Indeed, only 20 to 25 percent of all thrifts were profitable in 1981 and 1982.

A number of the unprofitable institutions became insolvent and many were liquidated or merged. In fact, during the period from 1980 to 1982, more than 350 institutions were closed or merged for supervisory reasons. However, some unprofitable thrifts were kept open through various combinations of assistance. The industry as a whole was given the opportunity to add earning assets.

As market interest rates declined a few years later, most institutions returned to profitability. In fact, by 1984, 70 percent of all thrifts were profitable. However, the condition of some institutions continued to deteriorate. Certain weakened thrifts misused asset powers then available or recently permitted by a few select states. Moreover, their weakened condition was further exacerbated by the regional downturn in economic conditions. These institutions are located primarily in Southwest.

The portion of the industry that is currently insolvent under regulatory accounting principles ("RAP"), is concentrated in six states -- Texas, Oklahoma, Louisiana, Florida, California and Illinois. (See Charts 1 and 2). In fact, sixty percent of all RAP-insolvent thrifts and fifty-five percent of all thrifts insolvent under generally accepted accounting principles ("GAAP"), are located in these states. Approximately half of these thrifts are in Texas alone. The insolvent institutions in these six states account for 80 percent of the losses suffered by both RAP- and GAAP-insolvent institutions during 1987.

These numbers suggest that the major problem currently facing the industry is regional in nature. Indeed, the problem stems in large part from the significant downturn in the agriculture and energy sectors of the economy in the Southwest. Two thirds of the losses suffered by RAP-insolvent institutions are located in only three states (Texas, Oklahoma and Louisiana) heavily dependent upon the farm and oil economies. Moreover, the regional nature of the problem is not limited to the thrift industry -- banks in these states are similarly experiencing difficulties.

The problem has been exacerbated by certain provisions of the Tax Reform Act of 1986 that adversely affect real estate investments. Most significant among these changes is the reduced depreciation benefit that makes investment in both commercial and residential property less attractive. Another change is the reduction in the value of the home mortgage deduction caused by the lowering of marginal tax rates. Other negative effects resulted from the limitations on offsetting losses on passive investments that affect limited partnership syndications and the elimination of the favorable capital gains treatment. While hardly sufficient alone to explain all the problems facing thrifts today, these changes have nevertheless created severe difficulties in the real estate market and the industry that helps finance it.

This brings me to a point I have made before and feel compelled to reemphasize -- the bifurcated nature of the thrift industry today. Currently we have, in effect, two thrift industries: one solvent, and the other insolvent. Approximately 90 percent of the 3147 institutions insured by the FSLIC, (2802 institutions) holding 93 percent of the industry's total assets is RAP-solvent. This 90 percent constitutes what I shall refer to as the solvent segment.

I would like to note that some argue that the Bank Board should use GAAP rather than RAP to measure solvency.[1] Since we currently regulate on the basis of RAP, RAP is the appropriate measure. Moreover, most industry calculations are not significantly different when computed according to GAAP. For example, using GAAP accounting, 84 percent of the industry (2637 institutions) holding 88 percent of the industry's total assets is solvent. Furthermore, the losses in the industry are concentrated in the RAP-insolvent thrifts. Adding the 165 GAAP insolvent institutions, a 48 percent increase in the number of insolvent institutions, changes this figure by less than 10 percent and does not alter the regional nature of the insolvency problem. (See Charts 1 and 2).

The divided nature of the thrift industry severely distorts industry-wide financial data.[2] This "skewing" phenomenon is even more dramatically demonstrated if we graphically depict the distribution of regulatory capital-to-assets ratios (see Chart 3). The distribution forms an almost perfect bell curve except for the relatively high percentage of insolvent institutions that fall within the very lowest net worth category. As this chart shows, over half of the institutions in the industry have capital-to-assets ratios above 5 percent. These institutions hold over half of the industry's assets.[3] Consequently, I shall first briefly describe the two industries separately.

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[1] GAAP with regard to thrifts is different from bank GAAP. This difference is most pronounced with regard to the treatment of restructured troubled debt for which bank GAAP is much more lenient.

[2] Unless otherwise noted, data used is for year-end 1987.

[3] Another way to lessen the distortion caused by the insolvent group is to compute industry-wide median instead of mean average. Using median capital-to-asset ratios, the condition of the industry reached a low in 1984 and has steadily improved since. (See Chart 4).

The RAP-solvent segment:

- holds 93 percent of the industry's assets;
- had a average return on assets ("ROA") of .25 percent (.34 percent for GAAP solvent);
- earned $2.7 billion in profits;
- had regulatory capital of $66.2 billion;
- had an average RAP capital-to-assets ratio of 5.71 percent (5.86 percent for GAAP-solvent).

In sharp contrast, the RAP-insolvent segment:

- had an ROA of negative 11.40 percent (negative 7.45 percent for GAAP-insolvent);
- lost $9.5 billion;
- had regulatory capital of negative $14.6 billion;
- had an average RAP capital-to-assets ratio of negative 15.73 percent (negative 9.25 percent for GAAP insolvent).

With respect to the capital of the entire industry, twenty-one percent of the institutions we regulate reported that they failed to meet their regulatory capital requirement which is based upon a ratio of capital-to-liabilities rather than assets. This twenty-one percent segment is comprised of the approximately 10 percent of the industry that is insolvent and another 10 percent group whose capital is below prudent levels.

Industry-wide thrift investments have become more diversified. Holdings of home mortgages and mortgage-related, pass-through securities investments declined from 71 percent at the end of 1980 to 53 percent in 1987. Non-home mortgages rose from 13 to 17 percent of assets; non-mortgage loans rose from 3 to 6 percent; investments in cash and securities increased from 10 to 14 percent and other investments rose from 3 to 10 percent. This latter change reflects in part an increase in repossessed assets at troubled institutions.

The earnings picture of the industry is also changing. Interest income declined from 93 percent of gross income for 1976-1980 to 87 percent for 1983-1987.[4] Contrary to some recent assertions, the fee income share of total income rose only slightly from 4.6 percent in 1976-1980 to 5.3 percent in 1983-87. Miscellaneous operating income (which includes net income for subsidiaries and mortgage banking operations) rose from 1.5 percent to 2.6 percent and non-operating income increased from 1 percent to 5.4 percent. The increase in non-operating income is due primarily to profits on the sale of assets, which probably is not sustainable in the future. Net interest income, that is the spread between the interest earnings on assets and the cost of funds, was up to 1.59 percent last year for the industry and a healthier 1.86 percent for the RAP-solvent group.

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[4] This data compares the past five year period with a recent representative five year period.

During recent years, thrifts have maintained a relatively high level of liquidity as measured by the ratio of holdings of short-term assets (assets eligible to satisfy the Board's minimum liquidity requirement) to total deposits and short-term borrowings. Last year, however, thrifts reduced their liquidity holdings such that the aggregate ratio declined to about 9.5 percent. This level of liquidity in the form of short-term assets appears to be adequate, especially since it can be augmented by borrowing from the Federal Home Loan Banks or other sources.

I would like to discuss briefly the Federal Home Loan Bank System. The twelve District Banks that comprise the System represent one of the strongest central credit facilities in the world. With year-end assets of $154.1 billion and a capital-to-assets ratio of 8.9 percent, these institutions turned a profit of over $1.3 billion in 1987 and paid out over one billion dollars in cash and stock dividends to the individual member thrift institutions. In 1987, the Office of Finance, the fiscal agent for the System raised funds through the sale of $70.4 billion in consolidated bonds and discount notes of the Bank System. In addition to publicly sold domestic debt issues, the Bank System continues to draw upon global and alternative sources of funding, thereby lowering the ultimate cost of funds to the thrift industry without increasing the Federal debt.

Although there are areas of concern, the thrift industry is solvent and viable. The problems in the industry, are for the most part, geographically isolated. Therefore, I believe the more important issue is whether the Bank Board and the FSLIC have the ability to manage the problems posed by the insolvent segment. Central to this issue is the condition of the insurance fund.

II. OVERVIEW OF FSLIC

A. Recapitalization

From FSLIC's perspective clearly the most significant development during the past year was the $10.825 billion recapitalization of the fund made possible through the enactment of the Competitive Equality Banking Act of 1987 ("CEBA").[5] That statute is also significant for its reaffirmation of Congress' commitment to insure deposits in all federally insured institutions. Title IX of CEBA contains Congress' pledge that deposits up to the statutorily prescribed amount in federally insured depository institutions are backed by the full faith and credit of the United States. We commend all who participated in the passage of this important legislation and are appreciative of your efforts. I would like to describe for the Committee the Bank Board's efforts to put the recapitalization mechanism into motion.

CEBA authorized the Bank Board to charter a mixed-ownership government corporation called the Financing Corporation ("FICO") whose sole purpose is to function as a financing vehicle to recapitalize the FSLIC. Since September 1987, FICO bond sales have raised $2.9 billion as of May 11, 1988.[6]

The Bank Board approved regulations and resolutions necessary to implement the FICO financing plan on August 28, 1987.[7] On the same day, the Bank Board appointed the three member FICO directorate and immediately set in motion the operations of the Financing Corporation.

The first FICO debt offering was priced on September 30, 1987, just six weeks after CEBA was signed into law. To insure the success of the initial offering, FICO officials, in cooperation with the District Banks, planned and coordinated an intensive educational effort to familiarize dealers and investors with FICO and FICO debt. Senior FICO and Bank System officials conducted presentations for the dealer community in New York City and in major cities throughout the country. The critical information we sought to communicate at these meetings was: a description of the FSLIC recapitalization plan; an explanation of the structure and role of FICO; a preview of the expected structure of FICO debt offerings; and, an analysis of the plans for repayment of principal and interest on the debt.

We have also made a strong effort to reach the large pool of investors in such foreign markets as Taiwan, Korea, Hong Kong and Japan. Because the Japanese in particular have been large purchasers of long-term bonds in the United States market, our goal is to capture more of this interest for our FICO bond sales.

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[5] Pub. L. No. 100-86, 101 Stat. 552 (1987).

[6] The funds raised by the FICO bond sales are transferred to the FSLIC in exchange for nonredeemable capital certificates and nonvoting capital stock.

[7] *See* 52 Fed. Reg. 33399 (Sept. 3, 1987).

Since its incorporation in August, 1987, FICO has conducted four public sales and two private placements that have resulted, as of May 11, 1988, in total debt outstanding of $2.9 billion. (See Table A). The coupon rates on these issues have ranged from a high of 10.7 percent for the first issue, to a low of 9.40 percent for the February 8, 1988, issue. The coupon rate on the most recent issue was 10.09 percent.

Initial public offering spreads between yields on FICO bonds and comparable 30-year Treasury bonds have ranged from 88 basis points in the February offering to 104 basis points in the March sale. In subsequent secondary market trading, spreads have widened further, to a high range of 112 to 117 basis points. This increase was in part attributable to the negative publicity about the financial condition of the thrift and commercial banking industries and to the fact that March 31 was the end of the fiscal year for Japanese corporations that had to accommodate tax and accounting changes. The Treasury Department estimates that Japanese corporations were net sellers of over $10 billion of U.S. government and U.S. agency securities in the month of March.

There are several factors that we hope will allow FICO to continue to narrow its rate spread over comparable Treasury securities. These include a regular market presence, broadening market awareness of FICO bond issues and increased public confidence in thrifts as the problems of troubled institutions are resolved. Another positive factor is the Federal Reserve System's acceptance of FICO bonds for open market operations and as a collateral at the discount window.

In late April, FICO was presented with an opportunity to privately place $750 million. The purchaser then restructured the security creating a stripped receipt product and sold it to retail investors. Since that private placement, three additional dealers have created stripped receipt products from existing FICO issues. The success of the sale of stripped receipt products from existing FICO issues has generated additional demand and expanded the pool of interested investors, causing secondary market spreads to narrow.

Institutional investors such as bank trust departments, pension and retirement funds, mutual funds, insurance companies, and foreign customers have accounted for approximately 75 percent of the placement of FICO bonds. Other important customers for the bonds have been banks, corporations, state and municipal accounts, educational institutions, savings and loan institutions and foreign investors.

In order to cover issuance costs and accrued interest, FICO, as of April 30, 1988, has collected from FSLIC-insured institutions assessments totaling $95.5 million.[8] The money received from the Federal Home Loan Banks' purchase of FICO stock ($257 million as of May 11, 1988) has been used to buy zero coupon bonds. These bonds are held in a segregated account and will be used to repay the principal on the FICO bonds at maturity. As of May 11, 1988, the par amount of the zero coupon bonds held in the segregated account was $2.9 billion. The establishment of this separate account for repayment of principal has bolstered investors' confidence in FICO bonds.

The Board is especially pleased with the participation of minority firms in the FICO bond offerings. The Board made a concerted effort to attract minority firms by holding a special informational meeting at which applications to become members of the FICO bond selling group were distributed. As a result, five minority firms and one woman-owned firm are members of the FICO bond selling group. In addition, five other minority firms are eligible to receive bonds through a reallowance process. Together, these firms received bonds totaling seven percent of the four public issues sold to date.

As a result of the reception that the FICO bonds have received from the investment community, we should be able to rely on a continuing stream of capital flowing into FSLIC over the next several years. Together with deposit premiums and other resources available to us, these funds have enabled FSLIC to begin resolving those cases on which it had previously been unable to act.

B. Insurance Premiums

In addition to funds raised through FICO borrowings in the bond market, FSLIC also obtains income by assessing premiums against insured institutions. Under the National Housing Act ("NHA") FSLIC has the authority to levy annual premiums equal to one-twelfth of one percent of the total deposits of insured institutions.[9] An additional premium can also be assessed each year against insured institutions to cover losses and expenses of FSLIC.[10] CEBA limited FSLIC's authority to assess a full additional premium against insured institutions.[11] Under CEBA the maximum amount of the additional assessment that FSLIC may charge annually must be reduced over a five year period to one forty-eighth of one percent, unless the Bank Board determines that severe pressures on FSLIC necessitate the infusion of additional funds. Under those circumstances, the statute authorizes FSLIC to levy an additional premium up to one-eighth of one percent of total deposits per annum.[12] At the end of the five-year schedule, the phase-down limitations on FSLIC's ability to assess a full additional premium expire.[13]

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[8] For the FICO's assessment authority, see § 302 of CEBA (new § 21(f) of the Federal Home Loan Bank Act 12 U.S.C.A. § 1441 (West Supp. 1988) (to be codified at 12 U.S.C. § 1441) and the FICO regulations adopted by the Bank Board. 52 Fed. Reg. 33,399 (Sept. 3, 1987).

[9] For FSLIC's premium assessment authority, see § 404(a) of the NHA, 12 U.S.C. § 1727(b) (1982).

On April 7, 1988, the Bank Board issued a notice that it would make a full additional assessment amounting to one thirty-second of one percent of total deposits against all insured institutions for the first quarter of 1988.[14] In determining that the full special assessment was required, the Board identified the existence of severe pressures on FSLIC which necessitated the infusion of additional funds. Chief among these were the significantly high losses and expenses incurred by FSLIC.[15] The Board also determined that the assessment of the full additional premium would improve the financing environment for selling FICO obligations to recapitalize FSLIC.

Although the Board anticipates that the condition of FSLIC may well require the assessment of full additional premiums for quite some time, on April 12, 1988, we issued for comment a proposed rule that would tie the additional special premiums to the capital condition of insured institutions.[16] Under the proposed approach, when the Board makes the statutory findings necessary to permit FSLIC to assess the full additional premium, institutions that pose a greater risk to the fund, as a result of their capital levels, would shoulder a greater portion of the payments. A primary purpose of the proposal is to offer insured institutions an incentive to raise and/or maintain more capital.

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[10] For FSLIC's authority to assess additional premiums, _see_ § 404(c) of the NHA, 12 U.S.C.A. § 1727(c) (West Supp. 1988) (to be codified as 12 U.S.C. § 1727.).

[11] Section 306(c) of CEBA amended section 404(c) of the NHA by adding paragraph 404(c)(2), entitled "Limitation on Amount of Assessment", (12 U.S.C.A. § 1727(c)(2) (West Supp. 1988) (to be codified as 12 U.S.C. § 1727 (c)(2)).

[12] 12 U.S.C.A. § 1727(c)(2). (West Supp. 1988) (to be codified as 12 U.S.C. § 1727 (c)(2)).

[13] _Id_.

[14] Resolution No. 88-256, 53 Fed. Reg. 12,460 (1988).

[15] _Id_. at 12,461.

[16] 53 Fed. Reg. 13,131 (April 21, 1988).

As proposed, any insured institution that meets the Board's minimum regulatory capital requirements for the quarterly assessment period, would not have to pay the difference ("the differential") between the yearly cap on the additional premium set forth in CEBA and the absolute limit on the additional assessment that can be made under any circumstances (_i.e._, one eighth of one percent per annum).

The proposed rule also requests comment on an alternative variable-rate approach for assessing additional premiums that would be tailored to an insured institution's capital level. Under this alternate scheme, FSLIC insured institutions with a regulatory capital ratio of 6 percent or greater would pay only the amount applicable for the quarter under the phase-down schedule contained in section 404(c)(2) of CEBA. Institutions with a regulatory ratio capital between the minimum regulatory requirement and six percent would be required to pay half of the differential (50 percent of the difference between the phase down amount and one-eighth of one percent), and institutions not meeting the minimum regulatory capital requirement would be required to pay the full additional premium (one-eighth of one percent).

Whether a threshold ratio of other than 6 percent regulatory capital should be employed is among the items on which the Board specifically sought comment. In addition, the Board has asked for comment on whether alternative measures of capital (_i.e._, capital as measured by GAAP) should be utilized.

In adopting this variable premium proposal, the Board read the National Housing Act as granting it broad discretionary authority to adjust the level of the additional insurance premium to reflect the losses and expenses of FSLIC. When this issue was considered several years ago, however, some questioned the Board's authority in this area. Therefore, the proposal requested comment on the issue of whether the Board possesses the authority to institute a variable schedule for collecting additional premiums. All comments on this issue will be fully considered, moreover, the Board would support legislation that affirms our authority to establish a risked-based premium system.

CEBA limited FSLIC's authority to assess premiums by the assessments made against insured thrifts by FICO to pay the interest and financing costs of its bonds.[17] Therefore, no

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[17] For the relationship of FSLIC's and FICO's assessment authorities, see § 305 of CEBA that added a new subsection (j) to section 404 of the NHA, 12 U.S.C.A. § 1727(j) (West Supp.

FSLIC insured institution can be required to pay, on an annual basis, an amount that exceeds the regular premium (one-twelfth of one percent) plus an additional premium, whether the premiums are paid to FSLIC, FICO or a combination of both.

Currently, under its authority, FICO is utilizing approximately 19 percent of the funds collected from the regular premiums paid by insured institutions to cover the interest and financing costs of its bonds.[18/] The premium income that currently flows directly to FSLIC, therefore, is that which is generated by the remainder of the regular assessment and the additional premiums that are collected from insured institutions.

FSLIC projects that revenues over the next ten years will total $37.6 billion. This includes the $10.8 billion that will be available to FSLIC through FICO borrowings over the years, plus the anticipated $14.8 billion that can be raised through regular and special insurance premiums over the next ten years. Also included is the income that will be generated through the sale of assets from existing receiverships. FSLIC projects that $8.1 billion will be raised from the sale of assets over the next ten years. Aggregating the revenue that will be derived from all sources and subtracting the amount that will be utilized by FICO and payments on FSLIC's earlier obligations, FSLIC expects to have about $20 billion in additional funds available for further case resolutions in the next three years and as much as $30.2 billion available over the next ten years.

C. Current Condition of FSLIC

As the attached summary financial statements indicate, (see Tables B and C) FSLIC finished 1987 with a $13.7 billion negative net worth due largely to an estimated $17.4 billion probable cost of resolving the problems of the 259 institutions in its current caseload. During 1987, FSLIC's caseload of troubled institutions increased from 183 to 259 which included 138 institutions that were in its 1986 caseload. In addition to the institutions that will probably require FSLIC assistance, we have identified another 252 FSLIC insured institutions that were GAAP insolvent in 1987 and may possibly require FSLIC assistance. FSLIC projects that the negative tangible net worth of these additional 256 institutions could give rise to an additional cost of resolution of at least $5.3 billion. The General Accounting Office has expressed the view that this estimate is low and has instead projected the potential cost of resolving the additional GAAP insolvent institutions is between $9 and $19 billion. It should be noted here that when the Board uses insolvency as a basis for appointing a conservator or receiver of an insured institution, that determination is based upon financial reports filed pursuant to the Board's reporting requirements.[19/] Since the Board's regulations currently require institutions to file reports on a RAP basis, the Board does not close institutions that may be GAAP-insolvent but are nevertheless solvent for RAP purposes.

As the GAO points out, however, a precise estimate of the potential costs of resolving the problems of troubled FSLIC-insured institutions is not possible. The ultimate costs of resolution will depend on a variety of factors including the quality of each institution's assets, future interest rates, and the economic outlook for certain sectors of the economy in which many of the troubled institutions operate.

There are some indications that the economy in Texas, the state with the highest concentration of insolvent institutions, may be turning the corner. In Texas, existing home sales at the end of 1987, were 13 percent above their level at the end of 1986. Another positive sign is that new construction in the state has nearly come to a standstill, which will allow demand in the glutted market to catch up with available space. In the fourth quarter of 1987 there were 10,900 residential building permits issued statewide, which is substantially down from the high of 69,800 issued in the second quarter of 1983. Further encouragement can be gleaned from a drop in the statewide unemployment rate. In February, the state-wide unemployment rate (not seasonally adjusted) was 8.7 percent, down from 9.2 percent a year earlier.

The recent surge in deposits nationwide for the first quarter of 1988 is another basis for optimism. FSLIC premiums are directly related to the level of deposits in insured institutions. As deposits increase, the revenues available to FSLIC also rise. In the fourth quarter of 1987 and the first quarter of 1988, net new deposits (i.e, deposited funds in excess of those withdrawn) received by FSLIC insured institutions averaged $4.5 billion per month. In the first three quarters of 1987, net new deposits averaged a negative $1.5 billion per month.

Recent speculation has suggested that Board of Directors of the Federal Home Loan Mortgage Corporation ("Freddie Mac") would consider using Freddie Mac's assets or income to aid the FSLIC. This is simply not true. Freddie Mac's ability to continue to

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1988) (to be codified as 12 U.S.C. 1727(j)).

[18/] Figures are derived from assessments collected between September 1987 and April 1988.

[19/] Grounds for the appointment of a receiver are specified in 12 U.S.C. § 1464 (d)(6) (1982) and are incorporated by reference in 12 U.S.C. §§ 1729(c)(1)(b) and 1729(c)(2) (1982).

fulfill its Congressional mission--to maintain the flow of mortgage money to our nation's leaders and homebuyers--is far too critical to jeopardize.

D. Projection for Future Amount of Capital Needed

Assuming that FSLIC will have approximately $30.2 billion available to resolve problem institutions in the next 10 years and that $22.7 billion may be necessary to resolve the problems of the 259 troubled thrifts currently in FSLIC's caseload ($17.4 billion) and the 252 additional thrifts that are GAAP insolvent ($5.3 billion), the Board projects that FSLIC possesses adequate resources in the near term to deal effectively deal with problem institutions in the thrift industry. This projection depends upon other segments of the thrift industry remaining stable and assumes no significant increase in interest rates or a dramatic downturn in other sectors of the economy.

The Board is aware of GAO's projection that the costs to FSLIC for resolving the problem institutions in its caseload and additional insolvent institutions could range from $26 to $36 billion. While the Board questions the methodology upon which GAO has based these projections, we would point out that its figures do not undermine the Board's position that the nature of the present problems in the thrift industry are manageable with the resources that will be available to FSLIC over the next few years ($30.2 billion). Unless the costs of resolving the troubled institutions currently in need of attention were to soar to the upper limits of GAO's projected figures or there were to be a dramatic increase in the number of troubled institutions, the income available to FSLIC will be sufficient to address the present number of troubled thrifts in the near term.

The Bank Board cannot guarantee that Congress will not be called upon in the the future to provide additional funding to FSLIC. However, by limiting liquidations only to those situations where no resolution alternatives are available, and by using FSLIC resources to leverage private sector participation, while maintaining the fund's ability to share in any future economic gains of the institutions it assists, we believe that FSLIC has the financial capability to deal with the identified problems of the thrift industry. It is important to note that no amount of future gains to FSLIC attributable to tax benefits, asset recovery, profit sharing and stock ownership are included in our estimates of resources available to resolve future cases.

III. BANK BOARD APPROACHES TO PROBLEM INSTITUTIONS

A. The Southwest Plan

Recognizing that nearly sixty percent of RAP-insolvent problem institutions are located in the Southwest region of the country, the Board has developed a plan specifically targeted to those institutions. The Southwest Plan was instituted after a resolution adopted by the Board on February 3, 1988. The plan is intended to resolve the problems of the 146 institutions in the Southwest that are insolvent under regulatory accounting principles, with initial emphasis on 104 institutions in Texas. The Board envisions that implementing the Plan will reduce the number of thrifts in Texas from approximately 280, with 1,800 branches, to approximately 160, with 1,400 branches. In addition to creating a more efficient and profitable thrift industry in the Southwest through consolidation, the plan is designed to eliminate the earnings pressures that insolvent institutions have placed on solvent institutions. To attract deposits, insolvent institutions have offered higher rates, bidding up the cost of funds for all institutions nationwide. Eliminating insolvent institutions in Texas should reduce the rates that healthy institutions have to pay.

The Board's consolidation of the thrift industry in the Southwest is intended to promote functional and geographic efficiency in the delivery of financial services by preserving the local orientation of the thrift industry consistent with appropriate statutory guidelines.[20] Three types of institutions are to be created under the Southwest Plan: "local" institutions will have assets of up to $800 million and will serve their local communities; regional thrifts will have assets of $800 million to $2.5 billion and will serve the area of the state in which they are located; finally, multi-regional institutions will serve more than one region and will have assets in excess of $2.5 billion. None of these three types of thrifts is expected to have state-wide operations.

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[20] Many of the consolidations that will result from the Southwest Plan will be implemented pursuant to the Board's authority to arrange emergency thrift acquisitions under section 408(m) of the NHA, 12 U.S.C. 1730a(m) (1982). Under section 408(m)(3)(B), when arranging acquisitions of troubled institutions, the Board must consider the following priorities: first, between depository institutions of the same type within the same state; second, between depository institutions of the same type in different states; third, between depository institutions of different types in the same state; fourth, between depository institutions of different types in different states.

After a careful analysis of the condition of the thrift industry in the Southwest, FSLIC divided thrifts into discrete groupings, arranged according to location. Those packages of consolidated institutions formed the bases for FSLIC's solicitation of bids, although interested acquirors were invited to suggest alternative packages and submit bids according to our request for proposals. To implement the plan, FSLIC, together with the Federal Home Loan Bank of Dallas, acted quickly to solicit statements of interest from thrifts domiciled in or having a presence in Texas and from private investor groups. FSLIC requested that proposals expressing interest in acquiring institutions pursuant to the Southwest Plan be submitted by March 31, 1988. A total of 150 proposals was received by the deadline.

The Board requires that the financial resources and the character of each potential acquiror be carefully scrutinized before the Board decides to proceed with a transaction. This process, in turn, requires several steps. First, FSLIC must determine whether those who submitted bids on a package possess the general qualifications to be an acquiror under the plan. At this level of review, the financial qualifications as well as the overall fitness of potential acquirors are carefully evaluated. Second, FSLIC must determine for each qualified bidder whether that bidder possesses the qualifications and capabilities required for the package upon which the bidder has expressed interest. Thus, for example, a bidder that might have the management capabilities to handle some institutions might not have the capabilities to handle the acquisition of a particular package. Finally, after completing this level of evaluation, FSLIC may reject a bid if it incorporates terms that are not acceptable to FSLIC. For example, a bidder may require a level of assistance that is not acceptable to FSLIC.

The time that elapsed between the Board's approval of the plan and the consummation of the first acquisition was from February 3 to May 13, 1988. Due to the complexity of merging multiple institutions, the Board required this time to avoid approving acquisitions that had not been carefully evaluated. Obviously, as we become more practiced, we expect that future consolidations will occur in a more routine fashion. Nevertheless, we intend to continue conducting supervisory examinations on all acquirors and extensive background checks on the officers, directors, and major stockholders of acquiring institutions before final approval will be granted.

On May 13, 1988, the Board approved the first acquisition under the Southwest Plan: the acquisition by Coastal Banc Savings Association of Houston, Texas, of four troubled Texas institutions with aggregate assets of approximately $470 million. Coastal Savings acquired all the deposits and assets of Alliance Savings and Loan Association of Houston; Colorado Country Federal Savings and Loan Association of Columbus; and

Security Savings and Loan and Cameron County Savings Association, both of San Benito. The acquisition raised Coastal's assets from $70 million to $600 million and added 15 offices to its five-branch network. Coastal has pledged to consolidate all of its offices to ten branches and a home office within a year.

Coastal will bring in new outside capital of $3.5 million from private investors and $3.5 million dollars of its existing capital; in return, FSLIC will provide a $32.6 million, 10-year note plus yield-maintenance and capital loss coverage on troubled assets. FSLIC will receive a warrant to acquire 15 percent of Coastal's common stock, will purchase approximately $12 million of preferred stock in Coastal, and will receive benefits from net operating loss carry-forwards. In addition, FSLIC will share in any gain Coastal realizes from the sale of problem assets. For problem assets sold, Coastal will receive ten percent of the gains over the original book value for the first $2 million of gain with increments of two percent for each additional $2 million up to twenty percent of the gains. FSLIC will receive the remaining percentage of the gains.

The expected total cost to FSLIC for Coastal's acquisition of all four institutions is $138.3 million. Under a rising interest rate scenario the Coastal transaction will save FSLIC $11.6 million over the cost of liquidation; if interest rates remain stable FSLIC's savings could rise to $16 million. Therefore, FSLIC will reap substantial savings from this consolidation while fully protecting the depositors and ensuring continuity of service to the communities affected.

Five days after approving the Coastal acquisition, the Board approved the acquisition of four additional troubled institutions by Southwest Savings Association of Dallas. The Southwest acquisition represented a very significant step in the development of the Southwest Plan. The four failing institutions involved had combined assets of $4.4 billion, and three of the acquired institutions were responsible for artificially driving up the cost of funds in Texas by paying among the top rates for deposits nationally.

Southwest Savings acquired the assets of Lamar Savings Association of Austin; City Savings and Loan Association of San Angelo; Stockton Savings Association of Dallas; and Briercroft Savings Association of Austin. Under this arrangement, FSLIC will assume its most significant ownership position in any institution. FSLIC will provide a $2 billion assistance package to the acquirors, including a three-year note worth approximately $483 million and yield-maintenance and capital loss coverage on all problem assets of the acquired institutions. In return, FSLIC will receive ninety percent of Southwest's first $60 million in profits and will own 50 percent of its common stock. In addition, Southwest is contributing $25 million of subordinated debt to the consolidated company as equity capital.

In addition to consolidating institutions that had contributed to the cost of funds problem in Texas, Southwest will decrease duplications and operating cost through a substantial reduction in the number of branches of the acquired institutions, concentrating on areas where there is duplication of branches.

The Board ~~is committed to~~ moving the Southwest Plan forward as expeditiously as possible. We are pleased that the consolidations that have been completed to date are adhering to the overall objectives that the Board established when it formulated the plan. A competitive environment is being enhanced, redundancies are being eliminated, and capable management is taking over. Significantly, from FSLIC's perspective, the use of cash to resolve problems is being minimized, and the FSLIC fund will have a share of the future profits of assisted institutions.

B. Other FSLIC Actions

During 1987 FSLIC resolved 47 troubled institutions at an estimated cost of $3.7 billion. Thirty-one of those cases were resolved by assisted sales to other financial institutions or to corporate and private investors, saving FSLIC approximately $400 million over the cost of liquidating the 31 institutions. From the enactment of the CEBA until the end of 1987, the Board completed sixteen assisted acquisitions and four liquidations, for an average of approximately one transaction per week. The Bank Board has set a goal for FSLIC to continue consummating transactions at the same pace this year. This goal is in addition to case resolutions under the Southwest Plan.

Given the size of its caseload and the available resources, FSLIC prioritizes cases according to the cost-effectiveness of resolution. In most cases, the preferred resolution is to sell a troubled institution ~~because that is~~ normally the least costly alternative for FSLIC. In addition, an assisted acquisition offers the potential of preserving the viable aspects of the troubled institution (such as its branch structure, its core deposit base, and its employees), while providing new capital to the industry in a manner that avoids the cost to FSLIC of operating a receivership.

During late 1986 and early 1987, FSLIC's marketing efforts were severely curtailed because of the depleted condition of the insurance fund. However, FSLIC embarked on a stepped-up marketing program late in the second quarter of 1987 and by year-end had marketed 47 institutions with total assets exceeding $16.5 billion and liabilities of $18.5 billion.

Through May 25, 1988, FSLIC was successful in resolving 23 troubled institutions (with consolidated liabilities of approximately 4.9 billion) for an estimated cost of 1.32 billion. Thirteen of these cases, with total liabilities of $3.5 billion, were resolved by assisted sales to other financial institutions or to corporate and private investors. These transactions saved the FSLIC approximately $252 million over the cost of liquidating the institutions. In addition, the Southwest Plan has resulted in savings to FSLIC of $532 million, for a total savings of $784 million this year.

For the second quarter of 1988, FSLIC projects 19 case resolutions. Twenty-nine institutions with assets totaling $5.7 billion are tentatively scheduled for marketing. FSLIC expects to market through both mail solicitations and telephone solicitations. The first and second quarter marketing efforts coupled with the institutions marketed during the second half of 1987 totaled over 100 institutions with assets exceeding $40 billion dollars.

One of the more significant acquisitions arranged by FSLIC apart from those made under the Southwest Plan involved the the acquisition last March of four troubled institutions by the Statesman Group, Inc. ("Statesman"). This transaction is noteworthy not only for the number of institutions involved, but also because it represented the Board's first exercise of its reinstated authority under section 408(m) of the NHA to override restrictions on cross-marketing of products and services between subsidiaries of the holding company and the newly acquired thrifts.

Section 408(m) of the NHA, first enacted by the Congress in the Garn-St Germain Depository Institutions Act of 1982 and reinstated by CEBA, authorized the Board, with certain limited exceptions, to arrange for acquisitions and mergers of troubled thrift institutions notwithstanding the provisions of any other state or federal law. The reinstatement of section 408(m) in last year's CEBA legislation was a reaffirmation of Congress' original intent that the Bank Board be provided with broad discretion to preempt those laws that would otherwise materially interfere with its ability to negotiate with potential acquirors and to resolve supervisory cases at the lowest possible cost to the FSLIC.

In approving the Statesman acquisition of three insolvent thrift institutions in Iowa and a fourth troubled savings and loan association in Florida, the Board agreed to waive certain cross-marketing restrictions generally applicable to thrift holding companies and their affiliates that could have prohibited the acquired institutions from marketing their affiliates' insurance products and services. A key factor in the Board's decision to grant these waivers was that Statesman's acquisition offer involved less financial assistance from the FSLIC than any other available alternative. In fact, the financial assistance provided by the FSLIC in connection with these acquisitions was $50 million less than the cost to the FSLIC of liquidating the four institutions. In making this determination, the Board also noted that: (1) but for the acquisitions, Stateman's insurance affiliates would have been able to enter into joint-marketing arrangements with the acquired institutions and to offer their products and services at the branch offices of the thrifts; and (2) the imposition of any cross-marketing restrictions, under the circumstances, would have been a material impediment to the acquisitions. Accordingly, these waivers constituted a proper exercise by the Board of its emergency acquisition authority under section 408(m).

The Statesman transaction also represented a significant step by the Bank Board in permitting an affiliation of a thrift and an investment banking firm. The moratorium on such affiliation contained in section 408(r) of the NHA expired on March 1, 1988; therefore, there is no longer any statutory prohibition on acquisitions of insured institutions by companies with subsidiaries engaged principally in certain securities activities. Even if this section had survived, however, the affiliation between the institutions and Stateman's broker/dealer subsidiary would have been exempt pursuant to Section 408(r)(2)(C) because the institutions would have had total assets of more than $500 million at the time of the acquisition. In approving this acquisition the Board imposed a series of firewall restrictions on the activities of Statesman's subsidiaries in order to insulate the deposits of the insured institutions from the activities of the broker-dealer affiliates.

As you are undoubtedly aware, we are attempting to resolve the problems of the troubled American Savings and Loan Association of Stockton, CA, ("American") the thrift subsidiary of Financial Corporation of America. The Bank Board continues to monitor the day to day activities of American while striving to find a solution that entails the least cost to FSLIC. On April 21, 1988, the Bank Board agreed to negotiate exclusively with the Robert M. Bass Group, Inc. for a period of 75 days concerning the possible sale of American. These negotiations are ongoing.

C. Tax and Other FSLIC-Related Legislative Interests

It is generally more cost effective for FSLIC to resolve the problems of troubled thrifts through assisted mergers and acquisitions rather than liquidations. In addition to the reduced costs, assisted acquisitions afford additional benefits, such as maintaining public confidence in the financial system by avoiding failures and liquidations of depository institutions.

Since 1981, the tax laws have contained a number of provisions ("the FSLIC tax provisions") that were enacted to help FSLIC fulfill its statutory mandate of protecting the safety and soundness of insured institutions. These provisions are currently set to expire at the end of 1988. We believe these provisions should be extended until the end of 1991 and we ask you to support such an extension.

There are two areas in which the expiring tax provisions affect the FSLIC's ability to arrange for assisted acquisitions of troubled thrift institutions. First, the Internal Revenue Code provides that assistance paid by the FSLIC in connection with an assisted acquisition will not be considered taxable income.[21] The benefit of this provision is not limited to the troubled institution or the acquiror, it also inures to the benefit of the FSLIC by reducing the amount of assistance otherwise needed. For example, if under current law the FSLIC must pay an acquiror $100 as an inducement to acquire a troubled thrift, the FSLIC may need to pay potential acquirors $150 if that assistance payment is to be subject to tax.

Second, special provisions in the Internal Revenue Code's corporate reorganization rules clarify that a FSLIC-supervised merger or acquisition can qualify as a tax-free reorganization, such that the net operating and built-in tax losses of the troubled institution can be fully utilized by the acquiring institution. Here again, although the nominal benefit of this provision accrues to the acquiring institution, in a very real sense, the benefit inures to the FSLIC as a result of contractual agreements between it and the acquiror requiring that tax benefits enjoyed by the acquiring institution must be accounted for and rebated back to FSLIC.

By making each dollar of FSLIC assistance go further, the extension of these provisions will not only allow FSLIC to resolve a greater number of cases, and to resolve them more quickly than it would if these provisions were allowed to expire, but will, we believe, allow for the most cost effective resoution of these cases from the Federal government's viewpoint. For this reason, we would urge the members of this Committee to encourage your colleagues on the Finance Committee to support an extension of these provisions for an additional three years.

The Board would also support three additional legislative initiatives that would substantially assist FSLIC. Two amendments would clarify authority that has been blurred as a result of recent judicial action and would substantially assist FSLIC in controlling legal and administrative costs. An amendment to the Home Owners' Loan Act would help to settle a dispute within the courts over the Bank Board's practice of requiring that proofs of claims against Bank Board appointed receivers are to be submitted only to the FSLIC claims process.[22] A recent decision by the Ninth Circuit Court of Appeals has questioned FSLIC's authority to decide claims.[23] The Seventh Circuit, however, has disagreed with that decision.[24] The administrative claims process is critical to controlling administrative costs in receivership and ensuring consistent and efficient decision making.

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[21] 26 U.S.C.A. § 597 (West Supp. 1988).

The second legislative clarification would affirm that under section 407(k)(1) of the NHA,[25] state authorities only retain jurisdiction over certain claims against a receivership estate when the claim involves state law and is being supervised under state law. The current statute has been interpreted to require a federally appointed and supervised receiver suing former officers for violating Bank Board regulations to proceed in state court.[26] Cases involving federally appointed receivers invariably involve Federal interests and require interpretation of federal law; therefore, it is important that the Federal courts have jurisdiction of these matters to avoid significant delay and loss to FSLIC.

Finally, the Board would encourage Committee consideration of a legislative interpretation concerning our authority to assess fees for processing FSLIC applications.

D. Management Consignment Program

Another technique for coping with problem institutions has been their placement in the management consignment program ("MCP"). The MCP was created in 1985 as an interim step to address difficult cases and to provide the necessary time to evaluate a final resolution. The MCP limits future losses to FSLIC by replacing bad management with new, more capable management that can initiate an aggressive workout program.

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[22] 12 C.F.R. §§ 545.4, 569a.3-9, (1987).

[23] Morrison-Knudson Co. v. CHG International, Inc. 811 F.2d 1209 (1987), petition for cert. pending sub. nom. FSLIC v. Stevenson Assocs., No 87-451 (filed Sept. 17, 1987).

[24] Lyons Savings and Loan Ass'n v. Westside Bancorporation, 828 F.2d 387, 392 (7th Cir. 1987).

[25] 12 U.S.C.A. 1730(k)(1) (West Supp. 1988).

[26] Tickten v. FSLIC, 832 F.2d 1438 (7th Cir. 1987), petition for cert. pending, No. 87-1965 (filed May 12, 1988).

The program was reassessed last fall and a separate division was created within the FSLIC to revise policies and guidelines designed to minimize the potential financial exposure of FSLIC. In addition, an executive level committee was formed to coordinate the program between the Bank Board and the District Banks. The committee has developed a new overall strategy for the program and is reviewing individual strategies with regard to each institution in the program.

Since its inception, 28 associations have left the program either through a FSLIC assisted acquisition or liquidation. Currently 52 associations with total assets of $17.6 billion are included in the program. FSLIC expects to resolve 8 MCP institutions during the next six months, exclusive of those in the Southwest Plan.

E. Capital Forbearance

In addition to our actions with regard to troubled institutions, we are now attempting to help marginal thrifts through the capital forbearance program. The capital forbearance program has been in effect since early 1987, when the Bank Board published a Policy Statement offering the possibility of forbearance to well-managed institutions whose weakened capital position was a result of problems in the energy, agriculture, natural resources, or other distressed areas of the economy.[27]

The program, which was to expire at the end of 1987, was extended by CEBA. Under a regulation that became effective on January 1, 1988, the program now provides that well-managed, viable institutions in economically troubled regions may apply for and receive regulatory forbearance from meeting their minimum capital requirements until as late as January 1, 1995.[28] This forbearance is intended to provide thrifts with an opportunity to restructure troubled loans and loan participations. It should be emphasized that a key feature of a successful forbearance application is a demonstration, through a business plan provided by the applicant, that the application has a thoughtful and realistic strategy for return to an adequate level of capitalization.

To date, only a limited number of thrifts have applied to participate in the program. As of May 1, 1988, seventy-three applications for forbearance had been received. Eighty-six percent of the applications were received in the Dallas and Topeka districts. Eighteen thrifts, or twenty-five percent of the applicants, are now receiving forbearance. Twenty-three applications for capital forbearance have been denied, twelve applications have been withdrawn, and twenty capital forbearance applications are pending. A number of districts, including Cincinnati, Boston, and San Francisco, have not yet received any capital forbearance applications.

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[27] 52 Fed. Reg. 6876 (1987).

[28] 53 Fed. Reg. 354 (1988).

IV. BANK BOARD ACTIONS TO MAINTAIN THE PROFITABLE SEGMENT OF THE INDUSTRY.

A. Supervisory Actions

A critical component of the Bank Board's approach to dealing with the major problems confronting the savings and loan industry is a strengthening of the supervisory function. While significant attention is, of necessity, given to dealing with the insolvent thrifts that pose an immediate threat to FSLIC, it is equally important that we adequately supervise the profitable portion of the industry, which comprises the majority of the thrift institutions. We must identify problems early and act promptly if we are to ensure that healthy thrifts remain strong.

To accomplish this objective, it has been necessary to enhance significantly Federal supervision of the thrift industry. As noted earlier, the regulatory and supervisory structure in place at the beginning of the 1980s was presented with unusual challenges as a consequence of the removal of deposit rate ceilings during a period of high and volatile interest rates, followed by the economic troubles in the energy and agricultural sectors. This combination of external forces weakened a number of thrift institutions, many of which failed.

Some of the institutions affected by the conditions were given the opportunity to grow out of their problems; were, in effect, given a "second chance." Unfortunately, the Bank Board's supervisory structure at that time was understaffed, both in terms of numbers of examiners and levels of experience, and, therefore, inadequate to deal with some of the more problematic institutions. As a result, a small percentage of thrift managers took advantage of the situation by taking on inappropriate levels of risk.

Initial efforts to solve the problem of inadequate supervisory resources were frustrated by federal personnel constraints. Finally, in the second half of 1985, the Bank Board was given authority to embark on a much needed restructuring and enhancement of its supervisory function. Critical to this effort was the transfer of the examination function from the Bank Board to the Principal Supervisory Agents of the various District Banks. By removing the examination function from federal personnel constraints, the District Bank System was able to expand the size and improve the quality of the professional examination staff.

As part of this restructuring process, the Board created the Office of Regulatory Policy, Oversight and Supervision ("ORPOS") as a separate office within the Bank System. This office is the successor to the former Office of Examinations and Supervision.

One of my first acts as Chairman of the Bank Board was to organize this new office along more functional lines: Policy, Supervision, and Regulatory Procedures. In addition, we retained outside consultants, on a gratis basis, to review the functions and operations of ORPOS and to make recommendations on how it might improve its efficiency. Many of these recommendations have been incorporated into the 1988 goals of ORPOS.

In cooperation with the Bank Board and the 12 District Banks, ORPOS is currently directing a comprehensive effort to improve the examination and supervision systems by emphasizing four major areas:

- o the recruitment, retention and training of high quality staff;
- o the quality and effectiveness of supervisory and examination policies and procedures;
- o the consistency and uniformity of the examination and supervisory activities at the 12 District Banks; and
- o the efficiency of processing applications.

Since June of 1985, the examination and supervision staff has doubled in size to over two thousand professional staff. Emphasis has been placed on hiring experienced staff. Many of the senior staff positions at ORPOS and in the Bank System have been filled with experienced supervisory personnel attracted from other state and federal regulatory agencies, the industry, and respected consulting firms.

To accommodate the influx of more junior staff, examiner training has been expanded. Under my guidance, steps have been taken to establish an examiner accreditation program which will be in place in June 1988. The first step taken at the end of 1987 was the adoption, for the first time, of a mandatory core curriculum of training for all examiners and supervisory personnel.

The Bank System is also currently developing specially trained examiners with expertise in securities transactions, criminal referrals, and local participations. Furthermore, the Bank system is enhancing its expertise both in Washington and the districts in the areas of electronic data processing, appraisals, compliance and real estate. Specialized staff will greatly enhance the effectiveness of the examination and supervisory processes in identifying problem associations before they become a significant risk to the FSLIC.

The Bank Board is refining its methods for deploying the increased supervisory and examination resources. Well managed and well-capitalized associations are now examined approximately every 18 months. Increasingly, "targeted" examinations are used to focus attention on those associations that pose the greatest risk to FSLIC, while at the same time reducing the examination burden on well-run associations.

ORPOS is updating and improving the entire set of the Board's supervisory and examination policies and procedures. To ensure consistent application of these policies, ORPOS is, for the first time, developing a multi-volume Regulatory Handbook for use by field examiners and supervisory personnel that sets out policies and procedures concerning such subjects as: examination procedures, thrift activities, applications processing, and compliance. This is a massive undertaking absorbing dozens of staff from ORPOS and the Bank System and is expected to be completed by year-end.

I am pleased to report that following the passage of CEBA, ORPOS worked quickly to develop appropriate materials to ensure that examiners were quickly apprised of the law's new requirements. It initiated a comprehensive series of training, participant manuals, and video tapes, and conducted three-day CEBA seminars at each of the 12 District Banks for over 2300 examiners and supervisory personnel. ORPOS also provided to the thrift industry copies of CEBA educational materials and guidelines, including a special video training tape. In addition, ORPOS has established a telephone hotline to provide answers to CEBA-related questions and will periodically publish a compilation, entitled CEBA Guide, of the most frequently asked questions and their answers.

With respect to consumer issues, ORPOS has recently established a special division to improve and enhance the System's compliance efforts for consumer-related regulations, trust activities and other requirements such as the Community Reinvestment Act and the Bank Secrecy Act. A first priority of the division is to develop materials that will assist institutions in performing a self-assessment of their compliance program.

To address the ever-changing, technologically sophisticated financial market of today, the Board introduced new computer assisted processes. The new processes included introduction of three systems: the Report of Examination System, the Examination Data System, and the Supervisory Action Control System. Collectively, these automated systems have markedly improved the examination and supervision processes by: providing an improved and standardized format for the examination report; broadening

the intra-agency availability of the examination report; and increasing the quality of information available on-line for analysis and review.

ORPOS is also significantly enhancing its ability to identify and analyze the systemic risks to the safety and soundness of the thrift industry. ORPOS recently created a unit responsible for establishing a systematic approach to evaluating risks to enable us to take corrective action before they threaten the viability of thrift institutions. The initial focus of the group, in conjunction with Board staff and the District Banks, has been to develop a national program to identify and address interest rate risk.

ORPOS has also initiated a quality control program for the supervisory functions at the District Banks. Each Bank has or will soon have its own internal quality control program for supervisory activities. ORPOS now meets quarterly with senior staff from each of the District Banks to review the Bank's supervisory strategies, and its progress towards meeting its annual objectives and goals.

A important part of the effort to improve the quality and consistency of supervision is a new peer review program to conduct in-depth reviews of the examination and supervisory functions of each District Bank. To date, ORPOS has completed reviews of five Banks, with two more in progress, and two additional reviews scheduled for 1988. The reviews are conducted by teams consisting of representatives from the Washington Office and supervisory staff from several District Banks. The evaluations focus on such issues as pre-examination analysis, work papers, examination reports, business plans, audit reports, monitoring capabilities, and responsiveness of supervisory actions to examination findings. I firmly believe that this peer review process will continue to lead to improvements in the performance of supervisory activities.

One of the persistent criticisms of the supervisory process is the delay in processing applications and in responding to requests for various types of decisions. ORPOS has responded to this concern by initiating a major review of the functions appropriate for delegation to the District Banks. The purpose of this review is to identify those decisions that, due to knowledge of particular local institutions and circumstances, are deemed more appropriately made at the local level District Bank.

B. Enforcement Activities

Enhanced examination and supervision of insured institutions will afford opportunities for earlier detection of fraud and abuse; however, effective deterrence of these acts requires vigorous enforcement. To combat acts of misconduct, the Bank

Board is drawing upon internal as well as external resources. We have instructed the directors of insured institutions about their obligations to protect their institutions from abusive conduct. As part of their overall duties, directors of FSLIC-insured institutions are expected to be the first line of defense against fraud or other misconduct.

We have also enhanced our cooperation with the Department of Justice including the FBI and local U.S. Attorneys Offices. As this Committee is aware, in 1985 the Bank Board joined with the other federal financial institutions regulatory agencies, the Department of Justice, and the FBI to form a Working Group to improve the referral, investigation and prosecution of fraud and insider abuse cases. An outgrowth of the Working Group is that attorneys from the Bank Board's Office of General Counsel and the Office of Enforcement now meet on a regular basis with FSLIC fee counsel, FBI representatives, and attorneys from the Criminal Division of the Department of Justice, to make sure that criminal referrals are made in a timely and competent manner; that any problems in communication or coordination are resolved expeditiously; and that meritorious cases are prosecuted aggressively. Another example of the outstanding cooperation that exists between the Bank Board and the Department of Justice as a result of the Working Group is the special Savings and Loan Fraud Task Force in Dallas. The task force represents the most concentrated effort to date, to prosecute financial institutions' fraud in this country.

Our cooperative efforts with the Justice Department are yielding gratifying results. The special grand jury in Dallas has already handed down indictments, and at least three defendants have entered guilty pleas. Federal prosecutors in Washington State and Louisiana have specifically thanked Bank Board staff for our assistance in obtaining convictions for criminal fraud which led to the failure of FSLIC-insured institutions. In addition, we have obtained over $20 million dollars in awards of restitution to FSLIC in sentencing proceeding nationwide.

I would like to assure the Committee of our continuing vigorous efforts to combat fraudulent conduct in the savings and loan industry. The Board is particularly adamant in the view that persons convicted of fraud receive terms of imprisonment. Such sentences are not only clearly warranted by the huge losses to a federal insurance fund, they are essential as a deterrent to others contemplating such activity. Anyone perpetuating fraudulent activity in this industry must pay a price.

C. Strengthened Capital Requirements

Another manner in which the Board can protect the health of the strong segment of the thrift industry is through enhanced capital requirements. The current regulatory capital requirement that became effective on January 1, 1987, can generally be divided into three components: a liability component, a contingency component, and a maturity-matching credit.[29] The liability component requires institutions to hold capital equal to six percent of their liabilities in excess of the level on their books on January 1, 1987. The capital requirement for the liability level on their books on January 1, 1987 was initially equal to approximately three percent and continues to increase each year (until it reaches six percent) by a fraction of the median profitability in the industry during the preceding year. An institution's specific initial requirement was determined on its base requirement under the regulation in effect prior to January 1, 1987.

The contingency component requires institutions to hold incremental capital against certain assets. The contingency component includes a two percent requirement on recourse liabilities, and a two percent requirement on standby letters of credit. It also contains a variable component for which the incremental capital requirement depends on an institution's actual capital level and its concentration in a specific asset category. These variable incremental requirements range, for example, from 0 to 10 percent on direct investments.

The maturity-matching credit allows institutions to reduce their capital requirement by up to two percent of liabilities for one-year and three-year cumulative hedged maturity gaps of less than 15 percent in absolute value. Gaps between 15 percent and 25 percent receive credit on a declining scale and gaps above 25 percent receive no credit. Institutions cannot use this credit to bring their overall requirement below three percent for the first three years of the regulation and not below four percent thereafter.

The Bank Board views the current capital requirement as a good first step in incorporating the risk of balance sheet activities. We note that the bank regulatory agencies have also now proposed to take more steps in that direction.

In accord with CEBA's directive that the Bank Board impose capital requirements consistent with those of the bank regulators, staff is presently reviewing our current capital rules as well as the rule recently proposed by the bank regulators. Any further action on capital requirements by the Board will depend on the results of the staff analysis.

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[29] 12 C.F.R. § 563.13, 561.13 (1987).

At present the Bank Board considers the 6 percent fully phased-in capital requirement as a good target, on average. It would not be appropriate, however, to suggest that a single number is necessarily appropriate for all institutions when the industry is composed of institutions with significantly varied portfolios and strategies. CEBA provided the Bank Board with the crucial flexibility to set individual minimum capital requirements on a case-by-case basis where such deviation from the industrywide standard is justified.

D. Case-by-Case Capital Regulation

CEBA, in response to the serious financial condition of the FSLIC, significantly added to the Board's statutory authority to impose and enforce capital requirements. Section 406 of CEBA authorized the Board to establish minimum capital requirements for Federal associations and insured institutions, and enabled the Board to alter those requirements with respect to an individual institution as was necessary or appropriate in light of the particular circumstances of that institution.[30] The Board is also authorized to issue a directive requiring an institution to increase its capital.

On December 22, 1987, the Board adopted regulations to set minimum capital requirements for insured institutions on a case-by-case basis and to establish procedures for issuing capital directives.[31] In adopting these regulations, the Board implemented the authority granted to it by CEBA to set the required capital levels of any individual institution as it determines to be necessary or appropriate for such insured institution in light of the particular circumstances of the insured institution.[32] These regulations allow individual minimum capital requirements to be established upon a determination that the insured institution's capital is or may become inadequate in view of its circumstances. It also sets forth discretionary standards for determination of appropriate individual minimum capital requirements. The Board delegated to the Principal Supervisory Agents the authority to set these individual minimum capital requirements that conform with guidelines issued by ORPOS and approved by the Board.

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[30] For the Board's authority to set case-by-case capital requirements see section 406 of CEBA, amending section 5 of the Home Owner's Loan Act ("HOLA"), 12 U.S.C.A. § 1464, (West Supp. 1988) and section 407 of the NHA, 12 U.S.C.A. § 1730 (West Supp. 1988).

[31] 53 Fed. Reg. 363 (1988).

[32] 12 C.F.R. § 563.14 provides for case-by-case minimum capital requirements.

The Bank Board does not regulate the capital level of savings and loan holding companies because FSLIC insurance only guarantees the deposits of subsidiary thrift institutions. We do, however, carefully regulate transactions between thrifts and their affiliates, including dividend payments by insured institutions. In addition, the Bank Board monitors the financial condition and managerial capabilities of those controlling insured institutions; regulates interaffiliate transactions; and monitors the financial condition of the holding company to identify incipient problems. In our experience, double-leveraging between thrifts and their holding companies has not proven to be a significant problem in the thrift industry.

E. Movement to GAAP Accounting as Required by CEBA

CEBA also required the Board to issue regulations prescribing "uniformly applicable accounting standards to be used by all insured institutions for the purpose of measuring compliance with any rule or regulation [promulgated by the FSLIC or the Board] to be same degree that generally accepted accounting principles are used to determine compliance with rules and regulations of the Federal banking agencies".[33] On December 21, 1987, the Board issued a final rule in accordance with the CEBA mandates. Under the Board's Uniform Accounting Standards Regulation[34] for all periods beginning on or after January 1, 1989, all unaudited financial statements issued by insured institutions, including counter-statements, and all financial reports filed with the Board are to be prepared in accordance with GAAP.

V. CONCLUSION

With $1.25 trillion in assets and 100 million accounts, the thrift industry is a significant element of the larger universe of the financial services industry. It continues to play a vital role as a major provider of home finance and as a "safe haven" for billions of dollars of deposits.

The Congress obviously held a similar view last year when it passed CEBA and the FSLIC recapitalization legislation. You and other members of Congress gave us, the regulators, the wherewithal to address the problems in the thrift industry and to begin its restoration to health. I have endeavored to present to you an accurate picture of the progress we are making, as well as the state of the industry. I have tried to avoid offering an overly optimistic projection of either, as that would be a disservice to you, the industry and the Bank Board. We continue to believe a large portion of the thrift industry is viable and should be given a chance to continue to grow stronger.

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[33] CEBA, §§ 402(b); 415(b)(1)).

[34] 12 C.F.R. § 563.23-3 (1987).

With the bond authority you have given us plus our other resources, we have the funds to make significant progress over the next few years. It is, therefore, premature to talk about a taxpayer bailout or a merger of the insurance funds. Let the next President and the next Congress assess our progress and then decide the course of future action.

Chart 1

States With More Than 15 RAP Insolvent FSLIC-Insured Thrifts

December 31, 1987

	Number of Insolvents	Net Income ($ Thousands)
Texas	109	6,050,332
California	28	-991,335
Illinois	23	-303,797
Oklahoma	18	-443,020
Louisiana	18	-177,662
Florida	17	-305,392
United States	346	10,010,875

Chart 2

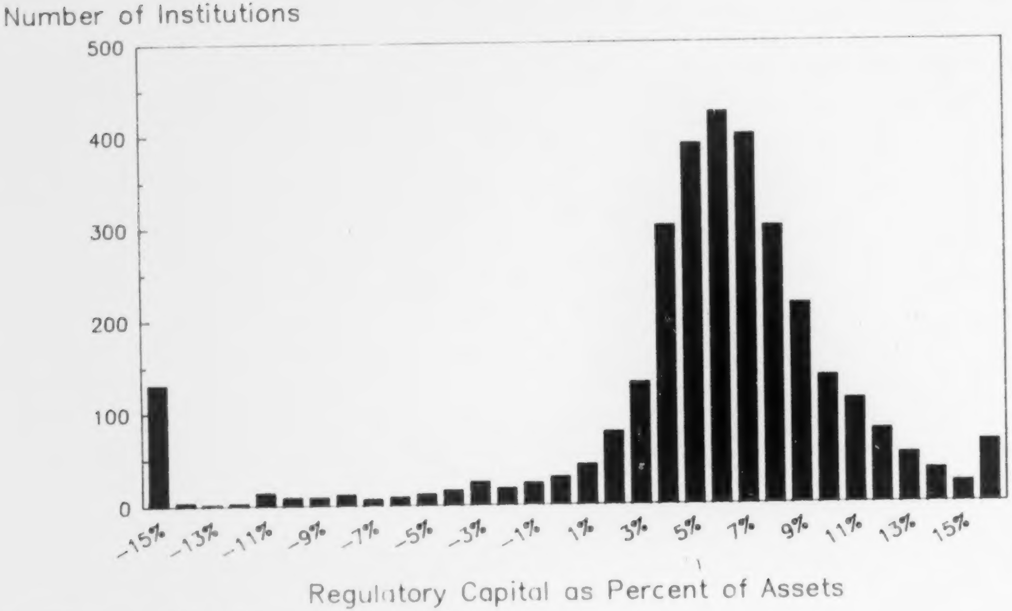
States With More Than 20 GAAP Insolvent FSLIC-Insured Thrifts

December 31, 1987

	Number of Insolvents	Net Income ($ Thousands)
Texas	128	-6,239,706
Illinois	57	-328,895
California	33	-1,465,336
Louisiana	28	-198,476
Florida	21	-306,962
Oklahoma	20	-448,944
United States	515	-10,983,267

Chart 3

Distribution of Capital-to-Assets
Among FSLIC-Insured Thrifts
December 1987



Negative NWTA signifies less than that level.
Positive NWTA signifies greater than that level.

Chart 4

MEDIAN CAPITAL/ASSET RATIOS
BY NET WORTH CONCEPTS

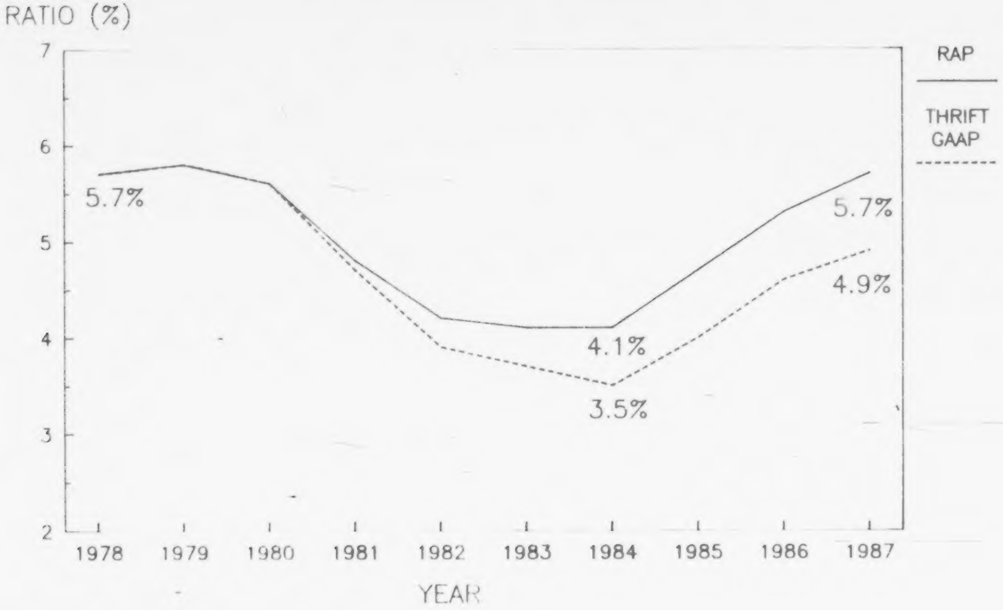


Table B

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
SUMMARY CONSOLIDATED STATEMENT OF FINANCIAL CONDITION

ASSETS	1987	1986
Cash and investments	$ 3,400,000,000	$ 4,100,000,000
Claims against assets of closed institutions (net)	4,900,000,000	3,800,000,000
Loans and assistance to insured institutions	2,200,000,000	3,000,000,000
TOTAL ASSETS	$ 10,500,000,000	$ 10,900,000,000
LIABILITIES		
Accounts payable and other liabilities	$ 100,000,000	$ -0-
Notes and interest payable to insured institutions	5,100,000,000	5,000,000,000
Notes payable to Federal Home Loan Banks	900,000,000	900,000,000
Estimated losses under existing agreements with acquirors	700,000,000	800,000,000
Liability for losses on unresolved cases	17,400,000,000	10,500,000,000
TOTAL LIABILITIES	24,200,000,000	17,200,000,000
INSURANCE FUND RESERVE (DEFICIT)		
Recapitalization funds	1,200,000,000	-0-
Primary reserve	(14,900,000,000)	$(6,300,000,000)
TOTAL RESERVE (DEFICIT)	$(13,700,000,000)	$(6,300,000,000)

Table C

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION
SUMMARY CONSOLIDATED STATEMENT OF INCOME AND EXPENSES

	1987	1986
INCOME		
Insurance premiums	$ 700,000,000	$ 700,000,000
Special assessment premiums	1,100,000,000	1,100,000,000
Interest income	400,000,000	500,000,000
Other income	200,000,000	100,000,000
TOTAL INCOME	2,400,000,000	2,400,000,000
EXPENSES		
Administrative and related expenses	300,000,000	100,000,000
Interest expense	300,000,000	300,000,000
Provision for losses related to claims against assets of closed institutions	1,800,000,000	2,900,000,000
Provision for losses related to acquisitions and mergers	1,700,000,000	1,100,000,000
Provision for losses related to unresolved cases	6,900,000,000	8,900,000,000
TOTAL EXPENSES	11,000,000,000	13,300,000,000
NET LOSS FROM OPERATIONS	$(8,600,000,000)	$(10,900,000,000)

Senator **Gramm**. Bravo! [Laughter.]

Senator **Riegle**. When Bill Seidman was here in our last hearing on this subject, he made the observation that in his view there had been serious regulatory lapses in the early 1980's, in terms of the savings and loan industry, and that was one of the major reasons, perhaps the major reason, why we had seen this build-up of problems and difficulties.

In your opening remarks, although not in your printed statement, you also talked about regulatory deficiencies. I would like you to elaborate a little bit on that.

As you now have been in this job 10 months, and you look at how this problem built up, I'd like as clear a sense as you can give us as to how it was that we did not see, the regulators did not see this happening, did not act sooner to limit some of these exposures that we are now trying to deal with.

Mr. **Wall**. Well, there are a number of factors that really are relevant to your question. Going back in time, the fact that the Federal Home Loan Bank that had the jurisdiction for what is now so often referred to as the Southwest, the five States of Texas, New Mexico, Louisiana, Mississippi, and Arkansas, was located in Little Rock. It was not located centrally to the States involved. It was not a convenient location in terms of transportation, and it was not located centrally with regard to the industry's size and deposits. And it took a long time for the system to bring about the switch of that bank from Little Rock to Dallas, for an example. That's one specific factor.

Senator **Riegle**. Let me just ask you. Am I correct in remembering though that one of the biggest savings and loans was in Little Rock itself?

Mr. **Wall**. Oh, yes. Oh, yes.

Senator **Riegle**. So I am not sure that geography is really the key.

Mr. **Wall**. No. It was part of it, I think, in terms of being able to get sufficient resources and the kind of people who were appropriate for the effort. As I say, there were many factors. I think the location of that bank was one, clearly. There was also the problem that I referenced earlier—and I am happy to expand upon here again; that is the Federal restrictions with regard to pay caps, the Fed has referenced that too. An article in the paper today notes the problem that they're suffering from and the need to get out from under the pay caps, the hiring limitations that existed historically, not just one administration, but administration after administration, for the FDIC and for the FSLIC and for other governmental agencies. In order to get out from under those restrictions, on July 1, 1985, the Bank Board delegated the examination and supervision responsibility to the 12 Banks and went from about 1,000 professionals, as of July 1985, to over 2,000 professionals today. Took the average starting salary from a beginning examiner from what was $13,800 in 1985 to basically doubled that figure. This gave the agency the ability to be able to hire the people of the caliber that I mentioned, in terms of the experience that they had, including the higher management.

So in an examination and supervisory sense at the Federal level, much has been done. At the State level, much has been done in some States; in some States, not enough. A number of aspects of the latter have brought about the problem.

Chairman Seidman has pointed out the regulatory relationship of his agency to the so-called savings banks, traditional savings banks in New England. I would point out, the same situation existed as far as the S&L's in that part of the country. They were well-regulated; the economy turned around, and institutions that had been troubled, both S&L and saving bank alike have recovered. So where there was a good regulatory structure in place and where the economy has turned around, they have been able to recover.

Senator RIEGLE. Well, it is clear that from all the evidence we have heard that the regulatory lapse that we had through a large part of the 1980's is a central part of this problem. There are other aspects to it.

Let me go to the other question that you raised yourself, and that is, why should the Federal Government be putting Federal Deposit Insurance and Federal guarantees and putting the Federal taxpayer on the hook for activities that are not authorized directly by the Federal Government? Why should we allow States to stretch out the operating authorities and then, in so doing, just automatically stretch the Federal Deposit guarantees right underneath those activities and put the taxpayer on the hook for those additional authorities?

Why should we do that?

Mr. WALL. Well, I think, historically, the Congress and the administrations over the years have done so under the banner of States' rights. The line has been drawn, and the question is whether not the line needs to be drawn somewhere else.

Senator RIEGLE. Well, why shouldn't the States provide the insurance? If the States want to stretch out the activities, why shouldn't there be just at least in theory, and I don't propose this, but why shouldn't they be on the hook for insuring the additional activities? Why should the Federal Government be on the hook for that?

Mr. WALL. I think various States where they had such institutions and such structures have discovered they were on the hook. There have been various States with private and quasi-private kinds of deposit insurance funds that have come into difficulties. Some of them have been, in quite orderly ways, liquidated.

Senator RIEGLE. That is not the problem we are dealing with today, you're right, in the sense where in the Ohio problem and the Maryland problem, but I am talking about the broad national problem quite apart from that.

Mr. WALL. Well, there were a lot of more States than Ohio and Maryland, Senator. Over a dozen States had similar problems. Some of them have liquidated their funds in an orderly way; some of them have had equally as difficult problems.

Senator RIEGLE. Well, that still leaves us with 38 that we haven't addressed, and I want to come to that. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman. Just a couple questions. Nice to see you, Danny.

Mr. WALL. Thank you.

Senator HECHT. I am used to seeing you up here, so you are in front of us now.

Senator RIEGLE. I'm sorry. I missed Senator Bond. He actually was next, but I couldn't see him behind you. Excuse me.

Senator HECHT. Go ahead.

Senator BOND. Let me just start off with a broad question. You have mentioned the things that you have done in restructuring the agency. Are there any things that you see necessary for Congress to do this year. You mentioned the moratorium. Are there other things that need to be done in the interim before we take a review next year of your progress?

RECOMMENDATIONS

Mr. WALL. Well, as a minimum, we have been before the Finance Committee and have been doing a lot of visiting with various Members of both the House and the Senate, as we could have the opportunity, to talk about what a change in the tax laws that applies to FSLIC, beginning effective January 1, 1989. Until then, assistance FSLIC provides is not considered as taxable by the recipient entity, whether it be an investor or whether it be an existing institution.

After January 1, 1989, that assistance will be tax-treated by the recipient company or investors, so as to, in a sense, increase our costs. We are asking that the Congress extend that exemption for FSLIC insurance tax treatment. We also have been supporting the FDIC's request that they be added to the special treatment provision. They are not currently tax-exempt. We are supporting the exempt treatment to them as well.

It is, I think, of everything that needs to be done, other than the question of the moratorium or dealing with the question of departures or switching and a perception problem related thereto, the most important one.

We then get off into other things that you as a very active and good lawyer are familiar with—the so-called Hudspeth issue, and the more recent Tickton issue. These deal with the authority that FSLIC has to operate as an insurance entity within the legal structure, and whether or not we have to take our recourse in State courts rather than Federal courts and other various, arcane questions, to at least the layman. But these are important ones to FSLIC, and in an insurance sense, and in an operational sense.

Senator BOND. Have you submitted specific legislative proposals on those?

Mr. WALL. We are in the final stages of preparation. One of these issues, the *Tickton* decision, has only recently occurred, and it is on its way, as I understand it, to the Supreme Court. Congress could act so as to predetermine the outcome or eliminate the need for the Court to rule. The other one, the Hudspeth question, is a situation where two courts have found contrary to one another, and that too is on its way up to a higher court.

We have prepared language. It is a question of whether or not the timing is appropriate.

Senator BOND. Last week we heard several critics of the Bank Board charging that delays in getting the Southwest Plan underway have really significantly increased the ultimate cost of the thrift industry clean up. They argued that the hopelessly insolvent thrifts merely were bidding up the cost of funds for everyone else and becoming steadily bigger problems. Their conclusions were not too complimentary and said that we, in fact, were not closing down these thrifts quickly enough.

How should we answer these critics?

Mr. **Wall**. Well, I think, with regard to the Southwest, particularly, we have made just incredible progress in a very short period of time, recognizing the size of the undertaking.

At the press conference when we announced the first Southwest Plan deal, we brought the documentation that was necessary to achieve it, and it was a stack of papers in excess of that. And that was just one of them. We were dealing with four existing companies being merged into a fifth. In that case, the resulting institution had $600 million in deposits. The second one that we did dealt with four insolvent institutions coming into a fifth that represent $6.4 billion in deposits. Those are incredible undertakings, and we achieved all of the negotiations related to both of them since our announcement of undertaking the Southwest Plan or the Southwest strategy, in the first week in February.

So from the first week in February, we went through 2 months of bidding and requests for proposal and came to closure in the middle of May.

I don't think that is very bad for what was involved, and recognizing we're dealing with 109 insolvent institutions at the same time. These are the first two groups to have emerged.

Senator **Bond**. I think we mentioned to you something about taking on a challenge when you asked for this job. [Laughter.]

Thank you, Mr. Chairman.

Senator **Riegle**. Senator Graham.

Senator **Graham**. Thank you, Mr. Chairman. I have a line of questions which starts with a policy and then moves to a specific example of how that policy has been implemented. And that is the policy which merges the regulatory function and the insurance function in the same entity. Historically, as far back as 1945, the GAO issued a report in which it recommended that those two functions being inherently in conflict should be separated. A decade later, President Eisenhower recommended a separation of those functions. We arrive at today still with the functions merged together.

I am concerned that the insurance function and the desire to avoid having to make payments has served to pervert or moderate the strictness of the regulatory function. And in your comments on page 18, where you state in the fourth paragraph that the discretion to preempt those laws that would otherwise materially interfere with its, the Board's ability to negotiate with potential acquirers and to resolve supervisory cases at the lowest possible cost to FSLIC, seems to be a recognition of the relationship between regulation and insurance considerations.

With that as a premise, last month I asked for you, as a representative of the Board, to provide recommendations as to whether you felt that Congress should take action to separate the regulatory from insurance function. I don't think we have received any specific regulations as to that.

Do you have any comments beyond what you said today?

SHOULD CONGRESS SEPARATE THE REGULATORY FROM INSURANCE FUNCTION

Mr. WALL. Senator, I could spend, obviously, more time than the committee has available in responding to the very major issues that you have raised. I would point out, as an example, in the legislation in 1982, what's come to be called Garn-St Germain, the Congress said explicitly that in order to provide an opportunity or a mechanism whereby the insurance entity, in that case, FDIC, would have the ability to deal with a wider range of prospective buyers, the Congress preempted what had historically been prohibitions against interstate banking, as an example. I think that kind of congressional policy setting vis-a-vis the insurance aspect, be it FDIC or us, has been and continues to be part of Congress' policymaking attitude.

With regard to the question of our responding to the inherent conflicts of interest, our agency has a number of specific and explicit conflicts of interest. I sit as the Chairman of the Federal Home Loan Bank Board; I sit as the head of the FSLIC. I also am the Chairman of the FHLMC. So there are specific and intentional conflicts built in. And clearly, if the Congress wants to change those, the Congress will have to address them.

We think there is a place and a purpose to be accomplished by such tensions, and clearly, I feel tensions when we move from one of those responsibilities to another, sometimes only within a matter of minutes. But it is clearly there and it gives us additional tools, it gives us additional flexibility, and I think it is, as well, a reflection on how the Congress has historically as I said earlier, of continued to support the thrift industry vis-a-vis the savings and the residential lending aspects of the industry.

Senator GRAHAM. Clearly, there are tensions. That is what conflict engenders. What I am concerned about is that there is a temptation to resolve those tensions in favor of relaxing regulations, so as not to have to exacerbate the financial implications of strict regulation. I think the question that the chairman was asking about the conflict of allowing States to have almost unbridled ability to expand the powers of the S&L and assumedly, in some cases, to increase the vulnerability to financial failure and then shift that consequence of failure to the Federal Government is one example of a negative consequence of merging the regulatory and the depository functions, and then some of the actions by the Board in terms of its efforts to save failed thrifts, which I would like to go in when I have my next round of questions, seem to me to illustrate within the Federal family, some of the perversions which occur because of this merger of regulatory and insurance functions.

And I would note that on the commercial bank side, we have a division of the regulatory function from the insurance function, with FDIC being a separate management leadership and separate supervisory staff to oversee the insurance function as distinct from the Fed and the Comptroller of the Currency's regulatory function.

Mr. WALL. Only partially. The FDIC regulates State-chartered institutions to a very significant extent. So there is a——

Senator GRAHAM. In terms of what is required in order for them to be eligible for FDIC insurance purposes.

Mr. WALL. In some States, the FDIC, by my understanding, is the total regulatory structure for State-chartered institutions. It does all of the examination and all of the supervision for some of the State institutions, at least in some of the States.

Senator GRAHAM. But their primary function is to review institutions for purposes of their insurance soundness.

Mr. WALL. Their primary function, as is FSLIC's primary function, but as I say, to some extent, several thousand banks have full responsibility and accountability to the FDIC as a regulator, not as an insurer. It is a very complicated structure that is out there and one that is often misunderstood.

Senator RIEGLE. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman.

Danny, looking at the total picture of the past years and looking at the different institutions that are failed, you've got to come to one conclusion, stupidity or fraud, in many of these instances. It is not just the oil crisis or energy crisis. There have been a lot of other things that have to be taken into account.

Are you pursuing criminal indictments on many of these institutions?

Mr. WALL. Oh, yes, Senator, very much so.

Senator HECHT. Please go into that.

CRIMINAL INVESTIGATIONS

Mr. WALL. In the State of Texas, there is underway and in place, the largest white collar crime task force that the Justice Department and the FBI have ever created, and it has come into place in large part by referrals from the FSLIC and to some extent the FDIC. The Justice Department and the FBI have a force of over 50 lawyers involved in that task force, and we have contributed permanent legal full-time staff as well, so as to work them through the intricacies of for example financial statements from a financial institution, or examination reports and the enforcement reports.

We are very much a part of that. There have been successful criminal trials completed in some of the other States where the problems were discovered more quickly. Further, in the State of Texas, in one particular institution, Vernon Savings, at least two of the very senior insiders have turned State's evidence. The estimate is that we can come to the successful completion of some of the criminal actions likely to ensue there, maybe a year earlier than would be the case, because of those insiders having come forward with information.

So we are very much involved in the referral process to Justice and to the FBI and continue to be involved in the task forces and in other parts of the country with the U.S. attorneys.

Senator HECHT. I am happy to hear you say that, because when one takes on a directorship of a financial institution, he is subject to many types of liabilities, and I am glad you are pursuing this.

Mr. WALL. Well, clearly, both criminal liability as well as civil liability.

Senator HECHT. Yes.

Mr. WALL. We have a number of actions for the civil liability as well.

Senator HECHT. All right. Now let me ask you another question that is brought to me often and publicly I would like to hear your explanation—not explanation: reasoning.

In banking circles, there is an old axiom, the first loss is the best loss. I know of many qualified savings and loan operators that own 5, 10 savings and loans very well-qualified, very well-financed, who would like to come in and buy other savings and loans, and they come to me. They say, "How do we go about doing all this?"

How are you disposing of many of these savings and loans that are troubled into the hands of people who want to buy them?

Mr. WALL. We have a bidders list that consists of very nearly 2,000 qualified companies, individuals, consultants, lawyers, various people who have identified interests on their own behalf or on behalf of a client or clients to receive bid packages. We provide the bid packages, depending upon what they have indicated as the size of the institution they are interested in, and where the institution might be located. As we go through our marketing discussions with staff, we may market a typical institution, by way of providing a bid package to 200 prospective bidders. So if someone is interested, it is a matter of contacting our marketing office. We have that office computerized, so that information is readily available and cross-indexed by size, the location, and so on. And clearly, there is always the opportunity for us to have lost someone in a crack, and if someone has not gotten the kind of attention that they deserve and that we want to give them, we would only ask that they make the contact again. But we clearly have a very active marketing under way.

In the course of preparing for this testimony, I had staff prepare an assessment of the various institutions that we are marketing around the country, and where we are in discussion, whether it be bidding, whether it be assessing bids received, and so on, and of the 20 States represented by the 20 members of this committee, I have only found three States where we do not have bidding under way.

Senator HECHT. In other words, you are encouraging this?

Mr. WALL. We are encouraging it; we are very much involved in it, absolutely. I made the announcement, I believe before you came in, Senator, that we are going to be announcing very early next week the entry of $100 million of new capital in an institution of over $1.5 billion dollars.

Senator HECHT. No, I heard that. I heard that. I heard that. That is good.

Mr. WALL. We are very pleased with that kind of an entry, and as people come to realize who the investors are and what the source of those funds are, they are going to be very impressed.

Senator HECHT. One last question. Are you giving out many new charters now?

Mr. WALL. No.

Senator HECHT. Not at all?

Mr. WALL. Not many. For a time there was a moratorium, nationwide. That is not the case any longer, but there are not very many cases where we've approved de novo charters. In some areas where there is interest for de novo charters, we are directing the people to troubled institutions, and there is interest on the part of those who would otherwise have been trying to create a new institution, in creating instead a new entity to receive an existing institution.

Senator **Hecht**. I am glad you are encouraging that. I see my red light is on. Thank you.

Senator **Riegle**. Senator Gramm.

Senator **Gramm**. Danny, as you are aware, there have been a lot of people in front of this committee and a lot of talk around town from people with faint hearts and open palms about a taxpayer bailout. [Laughter.]

I am committed to the idea that with enlightened public policy, we can avoid a taxpayer bailout.

Do you believe we can do that?

NO TAXPAYER BAILOUT FORESEEN

Mr. **Wall**. We believe that the numbers are such right now that barring any significant shift in our assumptions in the economy, generally, we are within striking distance of having dealt with all of the problems with the resources available. Now, I am not Pollyanna to say that absolutely, without question, but we are clearly within range, and it is clearly appropriate for the Congress and for the industry to give us the time to utilize those resources and for the next President and the next Congress to look over our shoulder and into our closets as to what success we have had and what problems remain if any.

Senator **Gramm**. Well, obviously, we don't know what is going to happen in the future. We don't know how the program is going to work, but you believe, based on the data you have right now and the experience that you have had in implementing your plan, that you can avoid a taxpayer bailout; is that right?

Mr. **Wall**. We believe we have the resources available that, as I say, put us within striking distance of the problem, barring any unforeseen shifts in the economy.

Senator **Gramm**. OK. Let me ask you a question about the Southwest and the Southwest Plan. Obviously, one of the things we've got going for us in the Southwest, is that we have an economic recovery under way. It is a slow and plodding recovery, but it is a broad-based recovery.

Given that this recovery continues and given the program you are implementing, when do you think we are going to reach the bottom, so to speak, in terms of being able to see the savings and loan industry in the Southwest move back into the black and back into a position to be making loans to build new homes, new farms, new factories?

Mr. **Wall**. In terms of staff resources, financial resources, and marketing, I indicated earlier that we would expect to deal with the so-called FSLIC caseload, which is 259 institutions, the most troubled institutions, by the end of 1989. So that it would seem to me that sometime shortly thereafter if, again, the economy continues as it appears to be, we would, as you say, see the end of the problem. And as I also indicated we would expect that by, I believe I indicated 1992, we should work through the second group of institutions, the additional 252, the extent to which they would remain as FSLIC cases.

Let me go back to highlight something I said earlier. In the time that I have been at the Board, we have dealt with five cases at no cost to FSLIC. That kind of thing happens; it continues to happen. As recovery occurs in a market or in a microeconomy, there is an asset that has value, and that asset can be sold or appraised on the basis of that value. Thus, an institution is taken out of insolvency. So that there is that opportunity and institutions continue to make those kinds of efforts. There also continue to be institutions that are able to get investment from the current owners or from those who would take an ownership position. And there are clearly, in the Southwest, institutions that discover the outcome of not recapitalizing themselves. If they are insolvent, we are there, and they are gone.

There is a good deal of pressure on those current owners to bring new capital, and it appears they are making every effort do so, even in what has been a hard-pressed area such as Texas.

Senator GRAMM. I want to join Senator Hecht in urging you to grab these people, that have violated the law and engaged in fraud, by the throat. I think, clearly, there has been a lot of abuse of this system, and I just want to urge you, if you need additional resources, to do that, to come before this committee and to ask for those resources.

Mr. WALL. Well, I suspect the hearing that is, I guess, scheduled for next month is likely to be dealing with that in some sense. I understand that hearings have been called to deal with outside legal counsel, and part of our outside legal counsel are indeed used for civil actions that we bring. The criminal actions, of course, are brought by the Justice Department and the structure otherwise, but I am sure we will be discussing it further even within the next month.

Senator GRAMM. Well, finally, Mr. Chairman, let me say that, Danny, I think you are off to a good start. I am proud of what you are doing. If you make this thing work, I am going to see that there is a statue built to you. [Laughter.]

And I want you to go ahead and talk to your mom and find out if you want the statue with the whiskers or without. [Laughter.]

Thank you, Mr. Chairman.

Senator RIEGLE. I want to just echo one thing that Senator Gramm has just said, and that is that I think in instances where fraud is uncovered and people, have, in a sense, looted the Government, that the full weight of the law has to come down, and that also should be fully understood to include anybody that is in the Government themselves. And I can tell you that by the time we finish scrubbing this problem, and we are just beginning, that anybody that has done anything wrong is going to be sort of pulled out into the broad light of day, and I must say I feel just as strongly about anybody that is found to have made this problem worse, may be on a Government payroll. And I suspect there is some of that as well.

So let that warning go out to everybody, because, you know, when the hammer comes down, I hope it catches everybody.

Mr. WALL. If I might highlight, in responding to the question that Senator Bond asked me earlier, I should have identified the fact that there is a relevant bill that is pending, which this committee has passed—which is why I didn't respond to Senator Bond with it in mind—S. 1886. S. 1886 contains the enforcement provisions that all of the bank regulatory agencies, ourselves included, have supported. Of course, it is pending on the House side, and we would encourage passage of these provisions, either as part of that bill or as a separate bill. That is an important aspect, and I didn't want to have neglected that in my response to Senator Bond.

Senator **Riegle**. Senator Garn.

Senator **Garn**. Thank you, Mr. Chairman.

Danny, I apologize for not being here for the first part of your testimony. I was downtown defending the Proxmire Financial Modernization Act in a speech. Unbelievably, the limo driver that was supposed to bring me back locked his car keys in the trunk—[laughter]—of the car. Then when they brought another one, the new driver came up saying how stupid the other driver was for doing that. I said, "Guys, fight after you take me back to the Senate." [Laughter.]

First of all, I would ask unanimous consent that my opening statement, which I was not here for, be placed in the record.

Senator **Riegle**. Without objection, it will be.

Senator **Garn**. I will just make a couple of comments about last week's hearings.

First of all, I do not wish to minimize this problem. It has been one that worried me a great deal, as you know Dan, for the 6 years I was chairman and you were staff director of this committee. It is a very serious problem, and I do not discount that. In listening to the testimony other than GAO's last week, I thought, for the most part, that the problem was exaggerated, particularly with Mr. Ely talking about $60 billion. I made comments in the committee at that time about pulling numbers out of the air. They finally all did agree that it was impossible to pull a particular figure and guess the amount.

But the point I wish to make is, having followed this problem for many years, through three chairmen of the Federal Home Loan Bank Board, there is no doubt in my mind that it is possible to manage this problem without a taxpayer bailout. What came out of the hearing last week, despite the fact that several of us tried to make the presentation more balanced, was that most of the press accounts reported the $60 billion or $64 billion figure. I realize that is sexy, but I wish the message that could go out of this place is that it is possible, not guaranteed, but as you and the Senator from Texas have talked about, it is possible, with good management, to handle this problem without a taxpayer bailout. I am one who does not favor a taxpayer bailout. I have given many speeches before savings and loan executives who want somebody else to solve their problem for them. They wish to find scapegoats here, there, or wherever they can for their own self-interest. I am adamant that taxpayer money should not be used to bail out losses caused by fraud and abuse that my colleagues have just been talking about.

I don't think anybody wants to bail out what happened in Maryland involving individuals that ripped off depositors and who now are in jail. Nobody should be asking the taxpayers to bail that out.

So I agree with what my colleagues have said about pursuing this from both a criminal and civil penalty standpoint. Nobody

TABLE A

THE FINANCING CORPORATION OUTSTANDING OBLIGATIONS

	Settlement Date	Principal Amount	Interest Rate	Price	Yield	Spread	Maturity Date
SERIES A-2017	October 8, 1987	$500,000,000	10.70%	99.75%	10.73%	90	October 6, 2017
SERIES B-2017	October 20, 1987	100,000,000	10.65%	100%	10.65%	82	October 20, 2017
SERIES C-2017	November 30, 1987	600,000,000	9.80%	100%	9.80%	90	November 30, 2017
SERIES A-2018	February 8, 1988	650,000,000	9.40%	99.75%	9.43%	88	February 8, 2018
SERIES B-2018	April 6, 1988	300,000,000	9.80%	99.71875%	9.83%	104	April 6, 2018
SERIES C-2018	May 11, 1988	750,000,000	10%	97.9375%	10.22%	109*	May 11, 2018
	TOTAL	$2,900,000,000					

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*Adjusted for no concession fee.

should be coming before this committee to talk about a taxpayer bailout for that kind of abuse.

Again, it is possible—nobody can predict what is going to happen to the economy, a real downturn could change basic assumptions. But it is possible to handle this problem without talking about a taxpayer bailout.

Also I see no useful purpose in constantly trying to find somebody to blame. What we need to do is find solutions and work together cooperatively without trying to assess blame to get the problem solved. I heard a lot of critics talk about how the administration is passive, how they are taking a hands-off attitude. It is a ridiculous charge. I think the facts are rather clear. The administration asked me to pull back my major financial institutions deregulation bill in 1986 and go only with a FSLIC recap. In July 1986, I determined they were right and decided to go along with their request for a $15 billion FSLIC recap, which this Congress refused to pass in October 1986. I think we need not be here today if that $15 billion recap had been passed nearly a year ago. We did not even approve $10 billion. Only in the conference, with the threat of a veto and extended negotiations between myself, Senator Proxmire, and the Secretary of the Treasury, Jim Baker, did we actually end up with more out of conference—$10.8 billion. This is still $4.2 billion less than the administration had asked for last year.

Having said all of that, I find no useful purpose in trying to find scapegoats, whatsoever.

Mr. Chairman, I will get to my questions on the next round.

Senator RIEGLE. Thank you, Senator Garn.

I think this is a very helpful discussion, in the sense that it starts to frame the debate and the inquiry and the search for answers and understanding of both what went wrong and what is required to fix it.

I want to just, myself, comment in response to something that you have just said and Senator Gramm before you, and that is the use of the phrase, "a taxpayer bailout." I doubt that we can find anybody in the Congress that is much interested in being for a taxpayer bailout. But in a sense, it is a somewhat disingenuous term, because what we are talking about here is the fact that enormous losses have taken place with depositors' money. And the fact of the matter is, people have gone into the savings and loans, different areas around the country, put their deposits in, the money has been invested in bad investments and the money has been lost. So the money is gone. And when the people go back to withdraw their money, either from a money market account or a savings account or from a certificate of deposit, the ability for that money to be there really depends in the end on the solvency and the backup of the Federal Deposit Insurance, because if the money that they deposited went into a bad investment and is gone when they come back to get their money, the money's got to be put there by somebody else.

Now the range of estimates that we got a week ago from the witnesses here was that we are underwater today in the savings and loan system somewhere between $20 billion and $60 billion. And people can agree or disagree where, in that range, but these are big numbers, and if you just take the middle of the range, if you just take $40 billion, which is halfway between 20 and 60, if the exposure is somewhere in that area, that is a lot of money. $40 billion, divided across the entire population of our country, is $160 per head in a nation of 240 million of people, and a family of four, that is $640.

But what we are talking about is the question of whether the savings that people put in are still out there to be retrieved when they want to go and take their money back or whether the money has been spent, invested and lost. And that is the difficulty. And the experts that I talked to, contrary to what you have said today, indicate that the losses are growing, not that the losses have been capped and are receding, but the losses are increasing.

Now I want to be very specific with that question today, because either the body of opinion that we are getting from many other people is in error or it is accurate. Now my basic question to you is, are you saying to us today that in your best professional judgment that the outstanding losses in the savings and loan system which you are trying to clear away as best you can, that that total is now coming down in the aggregate? Is it remaining about the same, or is that liability of losses out there actually growing today?

LIABILITY OF LOSSES IS GROWING

Mr. **Wall**. The liability for losses is continuing to grow, to the extent that we are not able to deal with these institutions and resolve them. There are continuing costs of funding the problem, the "Texas premium," as it has come to be called; that is, the differential that must be paid by institutions that are in that market area which is larger than just the State of Texas although it carries that monicker.

I don't believe I have indicated anything in the testimony, written or oral, that would suggest we believe that we have reached the limits of the size of the problem. We believe that we have reached the limits of the number of institutions. We believe that we have identified the institutions, and we are monitoring them more closely. We believe that the size of the problems within those institutions is increasing more slowly, because we are in better control of those institutions. But, clearly, there is a problem of continuation of growth of the size of the problem.

Senator **Riegle**. Well, that is a very important fact. So we have not yet cut this problem off at the pass. The aggregate losses are still increasing.

Now the other major fact that we have been given or opinion that we have been given by the other people who can be thought of as, I think, having expert opinion, is that the interest rate structure today is making that problem worse, in this sense, that institutions that are basically insolvent but still open, but bid up the price of deposits, and they can go out and advertise a higher interest rate than is generally available in the market, they can attract additional deposits, because they offer that premium, and the only way they can do that is if they have Federal deposit insurance there as the guarantor behind it, and as a result, they not only jack up the interest rate level across-the-board for all the other institutions that are trying to attract deposits, but, in fact, with that money, they turn right around and if they are no better than they have been in the past, they can spend it or invest it and lose it.

So, in effect, we are underwriting their ability to continue to both borrow money and go out, and if they don't invest it wisely, lose it.

Isn't that what is happening today in a number of instances?

Mr. Wall. There are situations where that has occurred. That is part of why I indicated we are in a better control than we have been as an agency regulating the industry. The so-called "Texas premium" spread is coming down. Board member Martin, one of my colleagues, is on the phone every week dealing with institutions that are within our jurisdiction, MCP's, where there are merger consent agreements, and so on.

We have a program that places funds at a lower cost than the market would require. Of the 8 institutions we dealt with in Texas within the last 2 weeks, 4 had been in the top 100 payers month after month, week after week. They are now. Vernon, that we took out of the market last November 19, $1,300,000,000 problem——

Senator Riegle. How many are left? How many institutions are left that are attracting this hot money that should be shut down today?

Mr. Wall. The top 100 payers are not all thrifts anymore. There are banks in that group.

Senator Riegle. I am not saying they are. I am saying, how many thrifts do we have in that situation?

Mr. Wall. You ask me how many are left. I can't give you the number exactly, but I can tell you that of the top 100 payers, which is what everybody monitors, there are no longer 100 thrifts, if there ever were. I don't believe there ever were. But of the top 25, let's say, there are more banks than there have been, because the thrifts are coming out. We are dealing with them and/or they are bringing down their bidding price, because we have these other programs in place. Your point is right on the mark, and, indeed, we have been on that mark with not one program but with no fewer than four.

Senator Riegle. Senator Graham.

Senator Graham. I can't resist the desire to editorialize before I go to my questions.

I was very concerned reading a Florida newspaper recently where one of our larger thrifts which had been a troubled thrift taken over I believe under FSLIC authority, the management publicly stated—and I admired their candor—that they had bought this institution in large part to deal with the junk bond industry.

My question is, why in the world are the taxpayers of America providing $100,000 deposit insurance behind an institution so that the management can engage in highly speculative corporate issues where they get the benefit if they are successful and the profit is privatized, but if they are unsuccessful the losses are socialized through the deposit insurance system.

I think that when blame gets distributed on this that Congress is going to have to take a substantial amount of the blame for creating an incentive system that capitalists are using—and I'm not referring to those who are doing it in a fraudulent or abusive or illegal way—but in a very aggressive commercial application of a system that we have created which results in these kind of I think antisocial incentives that do not serve any discernible public policy value.

That's my editorial. Now I'd like to turn to some questions on a specific instance and one that you refer to on page 17 and 18, and that is the acquisition of four institutions, three of which were in Iowa, one of which was in Florida, by the Statesman Insurance Group.

In order for this acquisition to occur, there had to be a definition applied, an interpretation, to section 408(m) which allows FSLIC to override existing State and Federal laws if that's necessary for the merger to go forward.

As I read that statute and as I read interpretations, including those that were made at the time of the 1987 CEBA law and a colloquy in which Senator Proxmire gave his interpretation, that the purpose was to deal with inhibitions that related to the acquiring institution's ability to acquire a failed or failing institution, not to expand the authority of the acquired institution.

The regulatory and insurance agency seems to have applied 408(m) to both sides of the equation, both the acquiring and the acquired institution. I wonder if you could recount what the basis of that dual application of the ability to override has been.

DUAL APPLICATION OF SECTION 408(M)

Mr. Wall. Well, Senator, let me first of all say the obvious, and that is that I'm not an attorney and that I deal in these kinds of things on the advice of counsel, as we did when I was on the staff of this committee.

We clearly view the 408(m) authority, which goes back to 1982, as giving the agency the authority to preempt other laws. The language of that particular provision is pretty clear, "notwithstanding any other provision of law, State or Federal." That's pretty clear and pretty broad and without question.

But further, I lifted a phrase or a sentence from the CEBA conference report that seems to be right on the mark as far as the particular Statesmen purchase of four institutions is concerned, and if I might, it's very brief and I'll quote it. This is the conference report on the legislation that has come to be called CEBA:

> If a life insurance company invested in or acquired a thrift institution under section 408(m), that section would preempt any State law that would prevent the company from continuing to engage in the life insurance business because of that investment or acquisition.

Now we think that's pretty straight on the question.

Senator Graham. Isn't that referring to the acquiring institution?

Mr. Wall. It seems to me to be difficult in terms of a chicken or an egg proposition, to distinguish between the acquiror and the acquired because they all become the same at a moment in time.

Senator Graham. But you use the word continuing. In this instance, at least I'm now speaking specifically to the Florida acquired thrift, they never had any insurance powers. In fact they were specifically prohibited by State law from having insurance power. So the concept of continuity and not interrupting continuity is inapplicable as it applies to the acquired institution.

Mr. **Wall**. Well, as I say, you have the advantage of being a lawyer and it seems to me to be in a layman's sense—a chicken and egg—when does an acquiror become an acquired? Because, as I say, at a point in time, they are one and the same. Not only am I advised by counsel, but I'm joined by counsel, if I might introduce Jordan Luke. He could respond as well.

Mr. **Luke**. Well, Senator Graham, I think there's a little bit that needs to be added. It's our position that we have not expanded the authority of the thrift as it sits in Florida today.

Senator **Graham**. And what's the basis?

Mr. **Luke**. The authority provided in CEBA for us to use 408(m) to override other provisions of law. The provision of law that I think concerns you was the prohibition on cross marketing. The prohibition on cross marketing which was contained in CEBA said, in effect, that the insurance company cannot market its products through the Florida S&L. All the Florida S&L is doing is providing a conduit that is marketing products of another institution, the insurance company. We looked very carefully into the question of whether we have the authority to use 408(m) to override the prohibition in 408(p) on cross marketing activities and we determined in a reasoned opinion that Congress did give us the latitude to do that.

Consequently, if prior to the acquisition of the S&L in Florida that S&L could have contracted at an arm's length basis with the insurance company to market its products—not to do it itself but to market its products—then it's our position that under 408(m) we can permit that same cross marketing to occur after the acquisition so as not to inhibit the insurance company from doing the acquisition.

Senator **Graham**. On page 19 of Mr. Wall's statement in the first paragraph, you make the observation that Statesmen Insurance Affiliates would have been able to enter into joint marketing arrangements with the acquired institutions and to offer their products and services at the branch offices of the thrifts, a statement that that authority preexisted the acquisition of the thrift by Statesmen. Is that the sense of the situation?

Mr. **Luke**. On an arm's length basis with an unaffiliated company, that's my understanding of the rule.

Senator **Graham**. I'd like if you could supplement for the record the basis of your legal opinion that that authority preexisted the acquisition.

Mr. **Luke**. We will go back and look into it.

Senator **Riegle**. Senator Gramm.

Senator **Gramm**. Thank you, Mr. Chairman.

Danny, I want to go back to this whole issue about the depositors and our commitment to them, but I'd like to start a little bit further back than that. As you're aware, you were here in September 1986 when Chairman Garn at that time managed to pass a $15 billion recap bill in the Senate. We never got the House to go to conference on it, and it died.

I know it's hard to go back after the fact, but could you give us kind of a ballpark guess about what difference it would have made in terms of the liability you're talking about trying to deal with now if this program could have started in, say, January 1987?

Mr. WALL. I would recall back to the discussion that Senator Riegle and I had a minute ago and that is that even now the cost, the size of the problem, is growing, albeit at a slower rate—a significantly slower rate. Even with everything else having remained unchanged but having provided more resources at that point in time, clearly he would have undertaken resolving the problem institutions more quickly, at a point in time when the size of the problem was smaller, and with a larger basket of resources. We have taken the $10.8 billion and we were able to leverage it in a 3 year period of time into $20 billion in a very conservative way under an equally conservative analysis and cash flow structure, what might the leveraging might have been a year earlier with $5 billion more, one could only guess.

Senator GRAMM. Well, I guess the thing I'm struck by with all of this talk about a taxpayer bailout, is that I keep hearing this talk from people who were saying even last year that this was only a $5 billion problem, that all we needed was $5 billion. In fact, the House adopted $5 billion. We adopted $7.5 billion, and we ended up in the conference with $10.8 billion. Now that wasn't quite within the scope of the conference, but the plain truth was we were overcoming the same special interests that are now saying that this is not a problem of the people who own charters of savings and loans, this is a taxpayers' problem.

So I guess the question really boils down to two things, and you addressed the first one. No. 1, do you have the resources with enlightened management to make a go of it? You said you think you do. Obviously you can't be certain about what's going to happen.

The second thing is, if you needed more resources, where do you think we ought to go? Do you think we ought to reach deeper into the pockets of the working men and women of America, or do you think we ought to go back to the people who hold these charters, the savings and loans?

Mr. WALL. It's a very difficult question. As I made the point in my conclusion——

Senator GRAMM. Well, I made it easy for you. [Laughter.]

Mr. WALL. There's something about leading a witness.

There comes a point when the thrift industry, as I said, it's being asked to expand its capital——

Senator GRAMM. Let me stop you there, Danny. We could have gotten $15 billion, right?

Mr. WALL. Could have gotten?

Senator GRAMM. Had we adopted Chairman Garn's bill at that time, we could have created the cash flow and borrowed $15 billion?

Mr. WALL. Yes.

Senator GRAMM. Do you believe we could still do that?

Mr. WALL. I think it is still possible.

Senator GRAMM. So we're talking about another $5 billion that's out there?

Mr. WALL. Well, another $4.15.

Senator GRAMM. But the point I'm trying to make again, we don't know what's going to happen and we don't know what the world is going to be like in the future. We can't be like that fellow in Sesame Street inside the garbage can, who says that everything is going to hell instantaneously. The plain truth is, you, the guy sitting in the cockpit, think that with enlightened policy we've got a good fighting chance of making a go of it?

Mr. **Wall**. No question about it, a good fighting chance.

Senator **Gramm**. Go at it.

Thank you, Mr. Chairman.

Senator **Riegle**. Senator Sasser.

Senator **Sasser**. Thank you, Mr. Chairman. I have a statement which I would ask unanimous consent be included in the record.

Senator **Riegle**. It will be made a part of the record.

IMPACT OF REAL ESTATE PROVISION OF THE 1986 TAX REFORM ACT

Senator **Sasser**. Mr. Wall, on page 2 of your statement you say that the real estate provisions of the so-called tax reform act of 1986 was contributing significantly to the deteriorating condition of the thrifts.

Can you amplify on this? Can you give us any idea of the extent that the tax reform act of 1986 precipitated or contributed to the decline?

Mr. **Wall**. These aren't discreet and separable impacts in terms of the industry. Clearly our industry is being real estate oriented, real estate dominated. The extent to which the real estate market and real estate values have been adversely impacted by the tax bill, by the lack of the syndication approaches for tax benefit purposes and so on, is something we can't quantify, but clearly it's had its impact. It's had its impact on local economies. It's had its impact on the saleability of real estate.

Senator **Sasser**. Well, I see that in my own State. I see it not so much with the thrifts that are relatively healthy there, but I see it with those who've engaged in real estate practices and engaged in real estate activities, and eventually I suppose that will work its way back into the thrifts. It's not done that yet. But in an era in which the thrifts were in worse shape I could see how it could happen much faster.

Mr. **Wall**. Well, real estate values have had a pretty dramatic effect on some of the thrifts because it's caused them to have to revaluate real estate assets of which they've taken ownership.

Senator **Sasser**. Well, some of the thrifts were in bad shape to begin with and many of these that were in bad shape appear to move into riskier activities and I assume they just went downhill even faster.

Is it your feeling that the thrifts went into the riskier activities in an effort to try to find a cure for their preexisting economic problems, or did the majority of the thrifts that were in good shape get into riskier activities and this accelerated or precipitated their problems? I'm trying to get to the question which came first, the chicken or the egg here?

Mr. **Wall**. I think we had a situation in 1978 to 1982 roughly, that so-called interest rate spread period, where inflation was high, institutions had to pay high interest rates to get deposits escalated, and the amount of income that they had on the existing portfolio was fixed consequently they were stuck in a bind and they had to try to cope with it individually and as an industry.

Senator **Sasser**. So they started moving to the riskier activities. What happened?

Mr. **Wall**. I don't want to get into a discussion of riskier because what was seen as an absolutely rock solid safe investment—that is, a fixed level payment mortgage—is not seen as quite so rock solid and without risk these days because of what we have learned can happen to interest rates. So as I say, it's a matter of definition here, but clearly there were institutions that tried to hit a home run, they tried to solve their problems in too short a period of time by doing things they weren't familiar with. If that's risky as a way of thinking of it, I think clearly I would agree with your observation.

Senator **Sasser**. Thank you, Mr. Chairman.

Senator **Riegle**. Thank you, Senator Sasser.

Senator Garn.

Senator **Garn**. Thank you, Mr. Chairman.

We have already talked a great deal about it, but last week when we had the experts estimate it, the problem was anywhere from $25 to $60 some odd billion. Specifically how do these ranges compare with your own estimates of the problem?

Mr. **Wall**. Well, as we indicated in our printed testimony, we agree with the GAO's assessment of our figures concerning the size of the problems. For the first group of institutions, 259—which are in our current case load—the estimate is $17.4 billion. We agree with the GAO that that's a realistic assessment of the cost.

The second group of institutions, which bring the total to 511—consists of the institutions that would be in the so-called GAAP insolvent category. We estimate a resolution cost of $5.3 billion and that's where we begin to diverge with the GAO. GAO says the cost could be from $9 to $19 billion. They also say we're not unreasonable with our estimate of $5.3 billion. As could be expected or appropriate by an accounting auditor, GAO took the conservative approach and increased the size of our estimate.

Our total estimate is $22.7 billion. GAO's total estimate is in the range of $26.4 to $36.4 billion.

Senator **Garn**. We've talked a great deal about the Southwest Plan and certainly it's been very greatly highlighted in the news. Are the resources being spent there, to solve that highly visible problem slowing your efforts to solve thrift problems elsewhere in the country?

Mr. **Wall**. No, Senator. As I indicated earlier, in preparation for this testimony I asked staff to prepare a list of the negotiations, discussions, bidding that's underway for the 20 States involved by the Senators on this committee, and there are only 3 States that either have no FSLIC case in their State whatsoever, and I might observe that Senator D'Amato represents one of those States. There are only 3 States of the 20 in which we have no activity at this point. Otherwise, we have active bidding and/or negotiations for case resolution in all the other States of the 50.

Senator **Garn**. Chairman Bill Seidman recently announced that the FDIC's top research priority for the 1980's is to study the insurance funds, including the possibility of a FDIC-FSLIC merger. What's your opinion of such a merger?

INSURANCE FUNDS

Mr. **Wall**. I think a merger of FDIC and FSLIC doesn't achieve anything economically. They certainly have their exposure, their fund, their industry. They have their challenges. We have our resources. We have our challenges. And it certainly is, in an economic sense, not a solution to anybody's problem to try to rob Peter to pay Paul because there isn't enough there to solve both problems—their own and ours. They clearly, as I say, have challenges in the same parts of the country we do where they're dealing with troubled institutions, some big, some small.

In an operational sense, I don't think you can achieve anything by a merger of the two insurance functions. They are different cultures. They are different although related industries and it doesn't appear to me, from a management perspective wise to propose merging those kinds of operations at a time of difficulty and challenge when you need the expertise and the culture that's there to deal with those respective industries.

Perhaps in an operational sense, it may be appropriate some day in the future, at a quieter time to consider some form of consolidation for the Government insurance or quasi-Government insurance entities—all of them. There are I observe, perhaps six or seven such insurance entities—FHA, VA, the FDIC, the FSLIC, the Credit Union Insurance Fund, the Pension Benefit Guaranty Corporation, Freddie Mac. There are a number of entities that have either directly or indirectly a government nexus to insurance or an insurance-like function.

Senator **Garn**. As you are well aware, there's been a bill introduced in the House calling for the abolition of FADA, the Federal Asset Disposition Association. What are your views on the usefulness of FADA and does FADA really improve the disposition operations of FSLIC?

Mr. **Wall**. I think there were clearly mistakes made with the original assignment to FADA and what they were tasked to do as far as a company that was created by the FSLIC. They were originally told to staff themselves up to prepare to handle basically all of the problem assets of the FSLIC. I think that was a mistake.

They proceeded to do that, however, and reached almost 400 people in size. We are now ratcheting that back down. We have new management. We have made that new management aware of what it is likely to have as a future responsibility which is significantly different than had been expected. But we believe that FADA has significant in-house expertise. We also recognize another benefit of FADA which is to have a closely held company to compete with the private sector so as to keep the private sector honest, if you please, in terms of bidding, and so as not to put us at the mercy only of private providers.

If nothing else had been provided by FADA then what they provided in services to the agency in one particular problem would have paid for all the cost that's been used for FADA to date. Specifically FADA provided services with regard to a very complex group of loans that were interrelated, interconnected, and for which participations had been sold in the so-called Craig-Hall negotiations that occurred now nearly 2 years ago. That was a several hundred million dollar package of loans. FADA was able to get people to the table and both because of their expertise and because those on the other side of the table knew that FADA knew what it was talking about, that it had and was real estate experienced, FADA was able to get those people to listen. They ended up compromising and coming to an agreement that we were able to go forward with and which continues to be very good.

Senator **Garn**. Thank you, Mr. Chairman.

Senator **Riegle**. I'm going to try to move through three things quickly so I'm going to ask you if you can on the first two to try to give me very narrow answers. I think they are questions that can be answered that way.

With respect to FADA's disposition of assets from the beginning up to the present time, if you were to take a rough gauge of the book value of assets that get folded in and then what they were able to dispose of, taking it all together, what are they getting in terms of the disposition value as against original asset value? Are they getting 50 cents on the dollar, 10 cents on the dollar, 90 cents on the dollar? What's been the running bottom line for FADA?

Mr. **Wall**. Senator, rather than risk picking a number off the top of my head, please let me respond to you in some detail on that. It is in excess of 50 percent, significantly in excess, but I just don't recall. [See p. 545.]

Senator **Riegle**. All right. Let us have that for the record.

Second, I appreciate the worksheets you've given us today and they do reflect a lot of effort. As I go through the worksheets, however, there's one thing in here that I think needs to be highlighted, and that is under the special assessment revenue that was contemplated in the 5-year phase-out schedule in CEBA, the total amount of that special assessment over that period of time was estimated to be $2.3 billion. In your workout plan here, you are extrapolating that out over the next 10 years and you're estimating special assessments in a total of $11.5 billion, or an increase of $9.2 billion.

Now if the map is right, in effect, what you're saying is that the healthy thrifts are going to be asked to cough up that amount of money over and beyond what we had anticipated in the special assessment phase-out schedule in CEBA by roughly $9.2 billion. Is that essentially correct?

Mr. **Wall**. Your mathematics sound correct. I would only observe we're talking about continuing the special assessment for 8 years, not for the 10 years.

Senator **Riegle**. In any event, one of the things that—I'm sure the industry will dig out quite readily without us highlighting it—but that's a pretty big number and maybe they can handle it and maybe they can't.

If interest rates were to ratchet up—and let's hope they don't—if the general level of interest rates were to ratchet up, say, another percentage point and stay there for any considerable period of time, how serious is that incremental pressure on the savings and loan industry in just the whole strategy workout that you have in mind if we have to try to do it at a higher interest rate environment?

Mr. Wall. A ratcheting up of 1 point is clearly within the range of the assumptions we have made. To the extent to which interest rates go up even higher, you get into some fancy economics because then you probably begin to see inflation occurring which improves the value of the assets that we have and the institutions have. At what point above 7 percent you begin to see other beneficial effects is hard to say. But we projected a moderately increasing interest rate as we priced the problem institutions as well as in our cash flow analysis.

Senator Riegle. Well, let me ask you this. I want to go back to another subject and a broader question in relationship to it. That is, when you know you have in effect an insolvent thrift out there today that's really underwater and you'd like to shut it down and you're not in a position to shut it down because in order to do that you've got to have a means and a mechanism for handling it in effect, so you can't go in and on a given day shut the door.

Mr. Wall. Well, there's another aspect to that, Senator. To do so is to take the most expensive course of action.

Senator Riegle. Well, it's not just a matter of—you're a little bit ahead of me. That's an important point to make.

Mr. Wall. I try to be.

Senator Riegle. Yes. Well, you're pretty good at it.

Mr. Wall. Thank you.

Senator Riegle. What I want to try to do is get the anatomy of this problem out there, the dynamics that are at work that you're trying to also get ahead of. I'm not sure how well you're doing in that foot race and hopefully you're getting better and better at it—not just you, but your whole effort.

But I think what needs to be understood is that we've got money-losing S&L's out there right now that we can't close. We don't have the way to close them efficiently and you're about to say that one of the reasons that we don't is that we feel that to close them immediately is more expensive. Now this becomes obviously a management judgment. If we're right, there are certain gains. If we're wrong, then maybe losses multiply.

But I'd like you now if you would just briefly try to explain why it is that savings and loans that ought to be closed and that are losing money can't necessarily be closed today or tomorrow morning in the way that logic might suggest that you would do with an operation that's losing money.

Mr. Wall. Well, Senator, let me assure you as someone who clearly has expertise and experience in management, as I know that you do, that we are doing those kinds of things. And in just the next 2 weeks you're going to see a number of steps that will reflect exactly that kind of assessment and analysis on our part. We are taking and will continue to take steps with institutions—I mentioned one this morning that has been on our case load for 3 years. During part of that time, there weren't the resources to deal with it and there's no question but that we now have new investors bringing $100 million—and experience as well in financial institution operation and management—to resolve and to take that problem forward.

We're going to be dealing with institutions in other ways as well, whether they be in some cases liquidations which is the most summary kind of step because there isn't another recourse, or in other cases taking other courses in terms of——

Senator **Riegle**. Let me do this. You've got a whole lot of these you want to try to wash out and restructure. You've got the one that's coming, the big one that's coming next week and you're giving us the outlines of. You've just done some in Texas with different arrangements and so forth.

How many are left to be handled just in raw numbers?

Mr. **Wall**. Well, the total case load as of the end of the year was 205, to which we then added 54 other institutions in Texas that are now insolvent that were not in that list, plus a very large one in California. So we have now 259.

Senator **Riegle**. That are waiting——

Mr. **Wall**. That was as of the end of the year. Since then we've done, I would say off the top of my head, 25 or 30.

Senator **Riegle**. So you've done 25 or 30 off a base of 259.

Mr. **Wall**. Yes.

Senator **Riegle**. And I assume at the same time some more go on the list, that you're having some that slide into that category.

Mr. **Wall**. There is a basket of the next group of 250.

Senator **Riegle**. So you're working some out but your base gets some new additions of others that have failed.

Mr. **Wall**. We're gaining headway.

Senator **Riegle**. You feel you're making a net gain but you still have something on the order of 225 out there?

Mr. **Wall**. Two hundred and fifty.

Senator **Riegle**. Well, you've worked off some. You've got some 225 or thereabouts out there still needing disposition and resolution that you're just not able to resolve in effect tomorrow morning, even though you would like to.

Mr. **Wall**. Well, we might do a couple tomorrow.

Senator **Riegle**. Well, maybe, but you still have a long way to go. Senator D'Amato.

Senator D'**Amato**. Thank you, Mr. Chairman.

Mr. Chairman, I'm going to ask that my full statement be placed in the record in its entirety.

Senator **Riegle**. It will be placed in the record.

Senator D'**Amato**. I would take the opportunity to reflect on part of it, Mr. Chairman. That part of it is the fact that every one of us on the Senate side knew that the moneys and the capitalization that we were putting forth last year was inadequate. As you recall, Mr. Chairman, you joined in our effort to increase that amount that the House conferees were willing to come to. I think they came to the table with something like $5 billion. As a matter of fact, we were able to get it up to something like $10.8 billion. Initially we had indicated we thought we needed at least $15 billion.

We're kidding ourselves. We're absolutely kidding ourselves. And Danny Wall and his crew is doing the best job they could possibly do under these circumstances, but let's not kid ourselves. If we're going to start to procrastinate and stretch this out, the bad, the incompetent—and there are bad and incompetent operations—are going to continue and they are going to continue to chalk up losses and in some areas where the economic situations are such that no matter how proficient the operators are, why, those banks are going to continue to chalk up losses as well.

So if we take the two categories, those which are in very, very difficult economic positions as a result of the geographic, socioeconomic conditions attendant, whether it's the energy States or the farm-energy combination, we're kidding ourselves. We're going to make FSLIC responsible for tens of billions that maybe it could have avoided. I think that we have an obligation to come up to the plate and say we've got to put more money, allocate, stop this arbitrary limit of only $3.5 billion by the way by your utilization of notes, you feel that you can stretch this out and hope that the economy turns around, these aren't really losses but they are potential liabilities certainly, and I would encourage you to continue what is a really heroic effort with more assets and that we make more assets disposable.

Now it's nice to say I don't want a bailout, and that's great. Let me go on record, I don't want a bailout. But if we're not ready to recognize the reality of the situation and that is to back up this FSLIC operation with more resources today, then potentially we will be using taxpayers' dollars to bail out these institutions. And the very same people who say "I don't want a bailout" simply because I'm not ready to address this situation, will be contributing to the inevitability of a bailout.

So, Mr. Wall, I'm not going to ask any questions. You've got a difficult task. I think it's upon us to come up with the resources to smooth that out, to give some more investor confidence as it relates to FSLIC. Two-thirds of the operations are making money. They don't offset the one-third that are losing. I think the chairman kind of indicated we've got to get into those failing operations as quickly as possible and it's not just a matter of the resources as it relates to money but obviously also it is the manpower and the personnel necessary as it relates as to whether you take them over, merge them, or close them down.

I'd simply say, given our limited resources that we have given to FSLIC and to Dan Wall, he's done a magnificent job. I think the responsibility is ours.

Mr. Chairman, you've held these hearings. And that is to say, let's not be the doom and gloomers that we get out of GAO and the other panel, but let's be responsible, acknowledge the problem, come up with additional resources, challenge our brethren in the House to meet this problem, don't look simply to increase the fees on the successful banks or get into this risk premium business because you're not going to raise sufficient capital to deal with that. That's not going to change this situation. I think if we give the infusion now we're going to be saving a lot of dollars in the future.

Thank you, Mr. Chairman.

Senator CHAFEE. Mr. Chairman, could I just put in this statement?

Senator RIEGLE. Yes, of course, Senator Chafee.

Senator RIEGLE. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

I'd like to go back to the line of questioning that I was pursuing and maybe if the attorney would like to join you again.

As I interpret your definition of the 408(m) provision—and I'm reading from the statement—excuse me. For the record, would you identify yourself, sir?

Mr. **Luke**. Yes, Senator. My name is Jordan Luke. I'm the general counsel of the agency.

Senator **Graham**. Reading from your statement at the bottom of page 18, you state that a key factor in the Board's decision to grant these waivers, having reached the legal opinion that you had the authority, was that Statesmen's acquisition offer involved less financial assistance from FSLIC than any other available alternative. In fact, the financial assistance provided by FSLIC in connection with these acquisitions was $50 million less than the cost of FSLIC liquidating the four institutions. I might say these are relatively small institutions. The one in Florida had a total asset base of $160 million and a negative tangible net worth of $35.6 million.

Mr. Wall, is it the intention of the Board in order to avoid increased costs to the fund or the potential of taxpayer bailout to aggressively use the powers of 408(m) to waive applicable laws in order to make the transaction a more attractive one for a potentially acquiring institution?

Mr. **Wall**. As I indicated, we believe that the Congress made policy statements beginning in 1982—I suspect there are some that are out there even longer standing than that—that say Congress is going to break its own precedent and provide for specific authority and direction in order to save the insurance fund, whether it be FDIC or FSLIC, or provide regulators the ability to save resources for other resolutions.

Are we going to use that provision aggressively? We're going to use it as we think is judicious and as we think Congress intended us to use it in order to provide forbearances or preemptions where it is appropriate, and as counsel has indicated, where we don't see it as violating some other basic principle to which Congress has spoken directly.

Senator **Graham**. Without conceding that you have properly interpreted congressional intent, would it be the logical extension of that policy application that a noninsurance acquiring institution, if it said:

> We will pay you $50 million more than we will otherwise do, or we will reduce the cost of the fund by $50 million if you will waive the current restrictions on this institution that we're interested in acquiring and allow it to go into the insurance marketing business as you had done with the institution in Florida.

Would you consider (a) that to be within your legal authority to do; and (b) a good policy decision?

Mr. **Wall**. Well, I think in terms of whether or not we see it in our legal authority, I think we would clearly look at, as I said, the other questions of policy that relate or that are similar to the question that Congress confronted, or perhaps the courts. We would and did also give it obviously very serious policy consideration, in that particular situation and in others. We have made it very clear that we recognize that we set precedent in that particular case. That particular buyer, Statesmen, an insurance group, had tried to buy thrift institutions over a period of more than a year. They had not received a positive reception at the Bank Board. We feel that Congress made a different case in the legislative statement of CEBA together, with the Garn-St Germain, which gave us the instruction to move in the direction Statesmen suggested to perhaps set other precedents as well.

Senator GRAHAM. And to move on a dual track, one to eliminate the inhibitions that related to the acquiring institution, in this case Statesmen; as well as removing inhibitions that related to the acquired institution, the thrift itself?

Mr. LUKE. Senator Graham, I should take that. The provision of 408(m) says that we may approve assisted acquisitions notwithstanding any other law. As I have interpreted that law, the statutes that we may override go to penalize or prohibit the relationship between the two institutions. They must have a material effect on it and they must relate directly to the acquisition. We are not directly affecting the powers of the acquired institution, except where they go to that relationship.

To give you an example, I have heard it said in other forums that the tax laws are providing too high a bracket for an acquiror. If we'll only use 408(m) to ease the tax rate for the institution, they can come do the acquisition. That's an easy one. That's not what the law provides and we're not in that business.

The same would be true if you wanted to ease the tax rate for the acquired institution. These only go to the acquisition, not to the powers of the institution.

Senator GRAHAM. Does that interpretation indicate that if a securities firm were to be the acquiring institution that that would mean that the acquired thrift would have securities powers regardless of what other statutory prohibitions might be?

Mr. LUKE. No. Again, we did not purport to give insurance powers to the thrift in the Statesmen case. In fact, in the Statesmen case, there is also a securities underwriting firm affiliated with Statesmen. We did not purport to give securities power to the thrift institution.

Senator GRAHAM. I know you didn't purport to do it, but if you were asked would you have had the legal authority under your interpretation to have done so?

Mr. LUKE. No, sir.

Senator GRAHAM. If Statesmen had come to you and said, "Our condition for acquiring this thrift would be for you to waive the restrictions on the acquired institution relative to its securities, real estate or other inhibitions," you would not consider to have been legally empowered to do so?

Mr. LUKE. No, sir, nor do I believe that we had the legal power to increase the insurance powers of the thrift either.

Senator GRAHAM. So your action on the Statesmen case was based on an assumption that the acquired thrift already had the insurance power?

Mr. LUKE. I don't believe that it is necessary to the analysis that the thrift have any insurance powers and that's why I held back on you. All we purported to do was to waive section 408(m) which prohibited cross marketing. There is no further step in it.

Senator GRAHAM. Well, in the context of my previous request for subsequent opinion, I'd like you—in light of what you've just said—to interpret what item No. 1 contained within the first paragraph on page 19 is intended to mean.

Mr. Chairman, I know my time has expired. I have some other questions that relate to this acquisition which I would like to submit in writing to Mr. Wall and request his response.

Senator RIEGLE. Senator Graham, we will certainly take those questions and put them in the record and we will submit them for answers. If you want to pursue this at any further length right now orally, I want you to feel free to do so.

Senator GRAHAM. I think those questions will be sufficient, reserving the right to submit written ones.

Senator RIEGLE. Very good. I will have some additional questions to submit for the record as well and we may have some on both sides of the aisle that we would ask you to respond to.

I want to just raise one other point in closing here, a specific point. We had the occasion, as you referenced earlier, to talk last week about some of your recapitalization efforts and plans in the Southwest area where the problems are so severe.

Some of the outside observers that have looked at some of those deals feel that they are pretty thinly capitalized. I mean you emphasized today the one that's coming next week where there's $100 million worth of new capital and I'm all for as much new capital as we can get into the industry. Clearly that's a large part of the solution. But I think there is a basis for concern on repackaging entities that are in trouble and because we have got more of them in the package rather than fewer of them in the package and with very little net dollar capital coming in—and I mean fresh money. I mean big checks coming in. I think that those that have some concern about that kind of a solution and whether that will prove to be viable over a period of time, I think there's some justification of that concern.

Now time will tell and you've obviously got to work with what you have to work with and you've got to make your best judgments, but I think it's important to put on the record that set of reservations and concerns about the degree to which some of those seem to be so thinly capitalized that we in fact may not be positioning ourselves to really solve the problem and I want to give you a chance to respond to that.

Mr. WALL. Well, we've identified the fact that these two institutions that we've mentioned—the surviving institutions—reflect the wide range of parameters of the negotiations that we've been involved in. In one case there was capital in the institution and it was a strong institution. The investors are bringing another $3.5 million to that institution. We are taking a 15-percent ownership position and that remains level. We get 15-percent of the value of that institution, its earnings, as it moves forward.

In the other institution, the current owners converted from subordinated debt to capital $27 million. It's not new to the institution. I don't want to suggest that it is, but it is now capital versus debt before which had demand on it.

Senator RIEGLE. Well, let me just say on that point, I really question what you've added there. You've taken one piece of the balance sheet and you've relabeled it and it's not fresh capital and in fact it may not have had a value anyway, even as a more senior kind of equity in a debt form. So in any event, I just want to file that.

Mr. **Wall**. It is clearly a different standing vis-a-vis the owners that what previously was debt now is recognized as capital.

Senator **Riegle**. It's not fresh capital.

Mr. **Wall**. That's right. In that institution we have 90 percent of the ownership of that institution for the first $60 million in value, thereafter 50 percent. So it indicates a wide range of the parameters in including the amount of new capital, the strength of the institution, and the willingness to bring new capital into the institution. When there is less willingness to bring in new capital, we take a bigger position. We have confidence in the management in both cases and that's why they were selected. So what we are going through is the process of matching management and capital with problem situations, all of the time, working to achieve the consolidation of the industry in that State which had become overextended, in a physical sense. There are 1,800 thrift branches in the State of Texas, far more than there need to be. There were 281 institutions when we started this process, far more than there need to be. So we are going through a consolidation, in a physical sense, of the industry as well as in an ownership sense. So we're eliminating some overhead expense and costs that currently exist in managing and operating those branches. It is not a matter of simply putting institutions together, but it is putting institutions together with good management, with existing and/or new capital some of which we have to put in. It is also a matter of achieving a savings, in an operational sense, as well as by getting those appetites out of the market. We talked earlier about the so-called Texas premium and ratcheting down the spread on the cost of funds for the healthy institutions, be they bank or thrift.

Senator **Riegle**. Let me just finally say—and I don't know if Senator Garn has any further comment or Senator Graham does—but I know I speak for the chairman of the full committee when I say that we want you to keep us posted on any new developments or anything that changes the complexion of things or any matters that arise that you feel we need to be dealing with directly in a formal sense. We want you to avail yourselves and we expect you to be in touch with us on very short notice if there's a requirement for that to happen.

Mr. **Wall**. We've made our assessment of what the resources are that we have and will have versus the problem as we see it. If we see any significant change in that view, you'll hear it from us, without question.

If I might make one observation about the sort of underlying thread that ran through the testimony last week, the so-called industry experts. I understand they all made their assessments in terms of the size of the problem. Everyone is free to do that. But I would draw the committee's attention to the similarity of what I am told all of them said. I have not had a chance to read their testimony, but I am told that each one of them talked about resolving the problems in basically the same way we're doing it. So while they talk about a different size of the problem perhaps, the method of resolution of the problem, as I understand it, as put forward by those witnesses is basically what we're trying to do, which is over a period of time, in a managed and in a straightforward way, to bring in new capital, new management, and/or to match existing management with new capital to bear on the problems of the industry.

Senator RIEGLE. Well, I think you can characterize it that way. I think you would also have to add to that that some of the witnesses felt that the scale of the effort that's being applied to solve the problem is far less than needs to be the case, that while the general approach, the workout approach, is the way we have to go, that far more needs to be applied to the problem starting now. I think there was clearly that additional sense of urgency and requirement that a number of them were reflecting to us. Obviously there is some difference of opinion on this.

Senator Garn, did you have a final comment?

Senator GARN. Just very quickly. First of all, confessing my bias that I think everyone is well aware of, I think, Mr. Chairman, that under the circumstances of an extremely difficult problem, you're doing as good a job as it is possible to do under these circumstances. I wish to compliment you on that.

Mr. WALL. Thank you.

Senator RIEGLE. The committee concludes today's hearing and stands in recess.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]

[Response to written questions and additional material for the record follows:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM
CHAIRMAN SEIDMAN

Question 1

Pathologists have identified a number of causes for bank problems in the Southwest. Some say it's the sour farm and oil economy. Others say it is fraud, noting the high incidence of abuse in some of the failed institutions. Others say it is excessive risk taking, noting that there are plenty of healthy, profitable firms operating under the same poor economic conditions as the failed institutions. Generally speaking, in percentage terms, what role do: 1) the local economy; 2) fraud; and 3) excessive risk taking play in the ills of banks in the Southwest?

Secondly, what is key to success in the Southwest? What course should bankers navigate to avoid future problems?

Answer

It is very difficult to make the kind of generalized assessment requested since all three factors are present at times in different combinations or to varying degrees in particular cases. It is accurate to say, however, that concentrations of credit, both to the oil industry and in real estate, loose underwriting standards, mismanagement, and the economy are the principal causes of the banking problems in the Southwest. Fraud has not been found to be a significant problem in the larger banks requiring assistance although evidence or indications of possible fraud have been noted in many of the smaller banks that have failed in the Southwest. While the fraud has not been the predominant cause of these failures, it has contributed significantly to failures in some instances. Overall, we believe that fraud and insider abuse have contributed significantly to about one-third of the bank failures in 1986, 1987 and so far in 1988.

In the short term, the key to success is an improving regional economy and stable interest rates. Over the long term, however, we believe that a very substantial consolidation of the unit banks is an important part of the solution. Bankers everywhere also need to reemphasize fundamental principles of sound lending, i.e., risk diversification and prudent underwriting practices.

Question 2

The banking industry faces some of the same woes as the thrift industry in the Southwest. To tackle that problem, FSLIC Chairman Danny Wall has proposed an ambitious plan to consolidate the number of thrifts through a number of mergers. What are your views of this plan? What are its advantages and disadvantages. Should a "Southwest Plan" be adopted for the banking industry?

Answer

We understand that the Southwest Plan is designed to do two things: improve operating efficiency in Texas S&Ls by merging weak thrifts into stronger institutions, and bring in private capital. There are worthwhile objectives. Consolidated institutions that are well capitalized and staffed with able management should be able to achieve operating efficiencies and survive over the long run. However we do not have sufficient knowledge of Texas S&Ls to evaluate the prospects for achieving the desired objectives.

We see no need for a similar broad-based plan for the banking industry in the Southwest where the problems are being resolved on a case-by-case basis in accordance with existing guidelines. As already indicated in our testimony, however, there is a need to provide the banking agencies with the emergency authority to require the consolidation of unit banks within holding company structures. Multi-bank holding companies often function in a fashion so that the unit banks fund the lead bank and then the large credits are concentrated in those lead banks. This way of operating has complicated our supervisory efforts as well as our efforts to resolve the potential failure of lead banks.

Question 3

Is it prudential banking practice to encourage banks to re-lend and re-lend to cover interest payments?

What are the public policy considerations you as regulators take into consideration when encouraging U.S. banks to participate in these heavily-indebted country new money packages and re-schedulings?

Answer

The FDIC neither encourages nor discourages banks to lend new money to, or to reschedule existing indebtedness of, lesser developed countries. We do, however, continue to embrace the Baker initiative principle that new money from all sources, when provided within the context of a suitable economic stabilization program, could serve to improve the quality of banks' international portfolios.

The appraisal of whether or not new money will improve the condition of the borrower is one which rests with bank management and its view of the policies undertaken by the country, the goal of which should be a return to normal debt serviceability.

Question 4

There are recent newspaper reports that banks are very hesitant, if not unwilling, to continue to participate in new money lending packages for heavily-indebted countries. Many of those who are hesitant are regional banks. What will be the effect if these banks elect not to participate and the money center banks have to extend the majority if not all of the new money? (Effects being the impact on the health of these banks, the ramifications for financing U.S. trade with these countries.)

Can the money centers afford to put together all the new money necessary?

Answer

The reluctance of some banks to participate in new money and restructuring programs and has made negotiations more difficult and has resulted in some new features. Several recent restructurings have incorporated the so-called "menu of options," such as exit bonds, which allow banks to withdraw from future new money participation. This unwillingness on the part of some banks should not significantly effect the health of the money-center banks that may have to provide the bulk of the new monies. The regulatory agencies have encouraged banks to increase their capital cushions against risk in their portfolios with substantial progress having been made over the past several years.

Question 5

In your view, if we have an economic downturn, what is your opinion of the most heavily-indebted countries' ability to continue to service their debts? What would the consequences be for U.S. money center banks?

Answer

It is difficult to make an across-the-board judgment of the effects of an economic downturn on debtor countries and U.S. money-center banks. It would depend on the specifics and the extent of such a downturn. In general, an economic downturn in the industrialized countries usually leads to balance-of-payments distortions in the debtor countries which would have a negative—

impact on the debt-service capabilities of these countries. On the other hand, an economic downturn accompanied by lower interest rates may lead to a situation where the negative effects on the merchandise trade balance would be offset by the positive effects on the interest paid on external indebtedness. Recessions of the types which occurred in the mid-1970s and early 1980s which were accompanied by higher interest rates would be a double-barreled shock to the debtor countries. Also, the impact of a recession on commodity prices, particularly oil, affects all countries differently.

As far as the impact on money-center banks is concerned, much would depend on the condition of the money-center banks at that point. That is why we believe it is so important that money-center banks take every responsible measure now to strengthen their balance sheets in order to meet the vagaries and challenges of the future.

Question 6

Commercial banks have been going through a difficult time adjusting to changes in the marketplace and absorbing problems in their loan portfolios.

Do you consider that the insurance fund is adequate to deal with the industry's failures?

Do you favor augmenting the fund in any way -- for example by imposing insurance premiums on foreign deposits?

Answer

At the present time, we believe our fund is adequate for every reasonably foreseeable contingency. In terms of augmenting our fund, we could certainly benefit at this time from the additional funds generated by a broadening of the assessment base. However, when viewed in the context of the world marketplace, assessing foreign deposits raises a number of issues that we believe are worthy of further examination -- possibly in Congressional hearings. For example, large multinational banks claim that the cost of foreign deposit assessments would create inequities that would weaken their competitiveness in foreign funding markets. Moreover, the assessment of foreign deposits is only one facet of a far broader issue, namely, the makeup of the assessment base and the scope of deposit insurance. Our staff is currently conducting a deposit insurance reform study -- A Deposit Insurance System for the 90s -- that will address these issues among others. Our target publication date is December 1988.

Question 7

In 1987, 184 failed banks were closed, and 19 were given assistance to remain open. Of the 198 failed small banks only one in twelve was assisted. The rest were shut down. Among middle sized banks, one in four was assisted. The only large bank that failed in 1987 was rescued.

Clearly the FDIC gives preferential treatment to the large banks. What is the FDIC doing to combat this discrepancy?

Answer 7

The FDIC does not give preferential treatment to large banks. In all cases we seek to minimize loss to depositors and disruption to the community using the most cost effective alternative available. Large banks, however, are different and require different treatment because of the impact their closure is likely to have on other banks and local and regional economies. We recognize, however, the public preception of unfair and preferential treatment and are making every effort, within statutory and policy constraints, to extend comparable treatment to smaller banks. Through June 28 of this year, for example, nine of the 15 assistance transactions involved banks under $100 million in assets. Moreover, most closed banks are handled through purchase-and-assumption transactions which have much the same effect as assistance transactions in terms of protecting all depositors and continuing banking services in the community. This is particularly true for so called Total Asset Purchase and Assumptions where loans are kept in a banking, not liquidating environment. We are becoming increasingly successful in arranging such transactions. It is also important to understand that, under FDIC policy, shareholders are virtually wiped out and management is changed in assistance cases.

As explained in our testimony, we have been giving some thought to alternatives that would extend comparable protection to smaller institutions. A copy of those alternatives was attached to our statement. All of the options, unfortunately, have some undesirable side effects.

Question 8

Your testimony and your actions suggest that a substantial shift in FDIC policy is taking place. More open bank assistance is being used. All depositors (not just insured depositors) and creditors are being protected wherever possible. Forbearance is being practiced. Cash is being preserved.

These phrases from your testimony could have come from a statement by the Chairman of the Federal Home Loan Bank Board. Is the FDIC beginning to follow the FHLBB down the slippery path to destruction by being too soft on losing banks?

Answer

As indicated above, more open-bank assistance is being used, in part, to eliminate the misperception of disparate treatment of large and smaller banks. All depositors and creditors are being protected only as a consequence of our efforts to limit our costs and otherwise protect the stability of the banking system, which is one of the reasons for our charter and existence. Forbearance was adopted largely at the behest of the Congress and we are being careful to confine that program to participants that have reasonable prospects for viability. The FDIC has stopped forebearance whenever such prospects were no longer evident. We are conserving cash as a prudential means of husbanding our resources in order to meet our insurance commitments in the face of whatever contingencies might arise.

It is important to remember as well that whenever insured banks fail or are assisted to prevent failure, stockholder equity is wiped out and most directors and senior management are replaced. This cannot be viewed as protecting losing banks. There is no inventory of insolvent FDIC-insured banks in operation. The FDIC also has not hesitated to use its authority to terminate insurance for banks in an unsafe and unsound condition. In 1987, we commenced 91 such proceedings and in 1988, 34 through June 14.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CHAFEE
CHAIRMAN SEIDMAN

Question 1

How many new banks have you chartered over the last 5+ years, and do you take any additional steps to see that they do not fail?

Answer

Please note that the FDIC does not charter banks. We insure banks chartered by the Comptroller of the Currency and by State authorities. Additionally, we have primary regulatory authority over only nonmember banks.

The FDIC has insured 1,898 new banks from 1983 through 1987. Of these, 1,469 were national and state member banks within the regulatory and supervisory jurisdictions of the Office of the Comptroller of the Currency and the Federal Reserve System, respectively. These banks are automatically insured upon receipt of a national bank charter and admission to the Federal Reserve System.

The 429 state nonmember banks chartered during this period are within the FDIC's regulatory jurisdiction. We normally engage in special oversight of such newly insured banks for the first few years of their operation. We require a visitation during the first ninety days and a full-scope examination within the first year of operation. After the first examination, we require that at least one visitation be performed in each 12-month period during which an examination is not conducted. We also require a full-scope opinion audit by a CPA firm for each of the first three years of operation. If the bank should be rated adversely, it becomes subject to more intensive supervision in the same manner as other banks similarly rated.

Question 2

Are commercial banks essentially private-sector entities which perform certain public sector services or are they quasi-public financial utilities on which societal demands can be loaded?

Answer

In our view, banks are essentially private-sector businesses that perform a critical role in our economy and benefit from certain government programs, notably deposit insurance. We have serious reservations about imposing societal demands and their related costs on these private entities, particularly where the burdens are unevenly distributed among competitors in essentially the same business. We think the better approach is for the Congress to appropriate directly, after suitable public debate, whatever funds are necessary to meet whatever societal demands the Congress determines should be met.

Question 3

- Why is the American public so unconvinced that their deposits are fully protected, when public official after public official states that there is no need for worry? Is it in any way due to a fear that supervision is inadequate?

Answer

We do not believe the American public is unconvinced that their deposits are fully protected. In fact, their continued dealings with troubled and insolvent banks and savings-and-loan associations is strong testimony to their faith in the Government's guarantee of their deposits. Insofar as the banking system is concerned, we do not believe there has been any serious breakdown in supervision. Nevertheless, we are making every effort to learn from our experience with failed and troubled institutions in order to improve our examination and supervisory programs.

Question 4

_ What are the major causes of the 10% or more turnover rate in bank examiners (Questions 13, page 159 of FDIC May 16, 1988 information submission)?

Answer

Most examiners leave for various unspecified personal reasons, retire or leave to take a position with a financial institution. It is our view that the current workload, travel requirements and inadequate pay levels are frequent contributing factors in the decisions of examiners to leave the FDIC.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM CHAIRMAN SEIDMAN

Question 1

In a recently released GAO report I requested, it was suggested that the regulators were too lax in responding to the LDC debt crisis in a number of areas:

- requiring reserves against debt,
- predicting problem countries.

This same report discusses how the federal regulators required only $2.3 billion in reserves. This past year, the banks set aside voluntarily $21 billion. However, GAO estimates -- based on secondary market estimations -- that the banks will require $49 billion.

Would you comment on GAO's assessment that you, as regulators, have been too lax in responding to the LDC debt problem?

Would you discuss GAO's estimate of the required reserves, as opposed to what the banks have set aside, and what you required?

Answer

Enclosed is a copy of our recent letter to Senator Proxmire (an identical letter also went to Senator Heinz) addressing the recommendations made in the May 1988 GAO report entitled, "International Banking: Supervision of Overseas Lending is Inadequate." Our answers to this question are provided in that enclosure.

Question 2

Last fall, I introduced S. 1117 to encourage the regulators to take a more pro-active role in responding to the LDC debt crisis? Specifically, S. 1117 seeks to encourage the regulators to:

a) be more aggressive in classifying countries that require reserves,
b) and reward countries that are performing better/responding to their debt problems.

Would you comment on this approach, especially in view of the recent GAO study I referred to?

Answer

Our answers to this question also are contained in the enclosed letter on the GAO report. Additionally, as a goal or statement of principle, we would certainly agree that countries that are performing better and/or responding to their problems should be properly rewarded.

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington DC 20429

OFFICE OF THE CHAIRMAN

July 1, 1988

Dear Mr. Chairman:

We are pleased to submit the enclosed statement of the actions of the FDIC to address the recommendations contained in the May 1988 report of the General Accounting Office entitled "INTERNATIONAL BANKING: Supervision of Overseas Lending is Inadequate."

With best wishes.

Sincerely,

L. Wm Seidman

L. William Seidman
Chairman

Enclosure

Honorable William Proxmire
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510

COUNTRY RISK RATINGS AND REQUIRED RESERVES

1. Recommendation: Require reserves for bank loans rated "Other Transfer Risk Problems (OTRP)", "Substandard", and "Value Impaired".

   We support efforts made by banks to increase general loan loss reserves and capital levels as a means of strengthening their position relative to risks inherent in their international loan portfolios. Between 1983 and 1987, primary capital, including general reserves, at the nine money center banks (which account for two-thirds of U.S. commercial bank loans to developing countries) increased by $29 billion, or 187%; and the ratio of LDC debt to primary capital at these institutions has decreased from from 224% to 101%.

   Section 905 of the International Lending Supervision Act (ILSA) mandates each federal banking agency to require banking institutions to maintain special reserves when the agency determines that the quality of the bank's assets has been impaired by a protracted inability of public or private borrowers in a foreign country to make payments on their external indebtedness or no definite prospects exist for the orderly restoration of debt service. The banking agencies' regulations implementing ILSA set forth the criteria to be applied in determining whether an allocated transfer risk reserve (ATRR) is required for a particular international asset, and the language of those regulations virtually parallels the wording in Section 905.

   Special, or specific, reserves (the ATRR), which are not counted as part of a bank's primary capital, are required for loans designated "Value Impaired"; and while such reserves are not required for loans designated "Substandard" or "OTRP", the volume and nature of these loans is taken into consideration in determining the adequacy of banks' general reserves and capital. While we recognize that "Substandard" and "OTRP" loans do possess elements of increased risk, we do not feel that the degree of problems fits the criteria for an ATRR. Many of these countries have made progress toward restoration of debt service through reform efforts. We feel that the risk inherent in these loans can be provided for appropriately by banks in the determination of their general loan loss reserves and capital positions.

2. Recommendation: Use secondary market price data, or if unavailable, statistically estimated proxies, as the primary consideration in setting reserve requirements.

   We do not agree that secondary market price data should be the primary consideration in setting reserve (either specific or general) requirements. The secondary market price of LDC debts is not necessarily indicative of a country's creditworthiness, as measured by ability to service its debts. Instead, prices are influenced by a number of factors which are reflective of the imperfections and inefficiencies of the LDC debt market. The market is fragmented, lacking depth or breadth. Trading volume is minimal in relation to outstandings and offsetting orders may go undiscovered. Wide disparities in the bid-ask spread are indicative of the illiquidity of the market. The lack of a formal bidding process, the secretive nature of many of the deals struck among multiple parties, and the difficulties in communication between would-be transactors render the secondary market as rather inefficient, where prices do not reflect all information and the volume of transactions does not necessarily respond to price changes. Trades in many cases are non-cash transactions, perhaps involving multiple items as part of a single transaction. In such cases, prices reflect the uncertain values of the asset acquired and various other influences, including tax considerations. Despite market imperfections and inefficiencies, we do give credence to the fact that market prices may contain important information; however, prices are not necessarily indicative of debt serviceability.

When these loans are evaluated solely in terms of debt serviceability using a 25% debt service ratio (debt service to exports), widely accepted as a healthy benchmark ratio, the serviceable level of loans outstanding to the six largest LDC borrowers approximates 70% of book value, significantly higher than the average secondary market value for these debts. Thus, our position is that secondary market values should not be the primary determinant in setting reserve levels, but should be considered as a source of input, along with other factors in determining appropriate reserve levels. We believe that determination of adequate reserve levels should be a matter of managerial and supervisory judgment, rather than a mechanical exercise.

In addition, we believe that the use of secondary market prices to value banks' LDC portfolios is contrary to Generally Accepted Accounting Principles, which do not require marking to market assets which are to be held to maturity. A blanket markdown of LDC portfolios would be inconsistent with the treatment now accorded all other bank assets which are being held to maturity.

3. Recommendation: Revise the rating scale so that the Interagency Country Exposure Review Committee (ICERC) can forecast the nonimminent development or elimination of debt servicing problems.

GAO has accepted our comment that we do not consider "Weak" ratings to be forecasts. Rather, the purpose of this categorization is to point out that, in such a case, the country is experiencing a number of economic, social, or political problems which, if not reversed, could threaten orderly repayment of external debt. A "Weak" categorization indicates countries with potential debt service problems, which should be considered in relation to the level of outstandings, as well as of capital.

The purpose of the ICERC process and its "Weak" categorization is not meant to be a statistical exercise in prediction of actual debt service problems. Rather, the intent is to highlight exposures which, considering the potential for debt service problems, are considered high in relation to capital. Input to this process includes tools such as the screen of economic indicators and country studies, as developed by the Federal Reserve Bank of New York, and briefings by bankers as well as Treasury economists. In highlighting "Weak" categorizations, the intent is to point out potential problems in relation to capital levels, as interpreted from these various input sources, rather than to serve as a statistical model to forecast when debt service problems will either occur or be eliminated.

4. Recommendations: Communicate "Weak" ratings to banks owning significant amounts of this debt immediately after ICERC meetings; also communicate the probability of future debt servicing problems when ratings are communicated to banks.

At present, the categorizations of "Weak", "Moderately Strong" and "Strong" are used in conjunction with the examination process to highlight exposures which represent concentrations which are considered high in relation to a bank's capital. The use of the "Weak" categorization is integrated into the examination process of the bank with respect to risk diversification, capital adequacy, asset quality, liquidity considerations, and management policies, among other things. As we have indicated, the "Weak" categorization is not meant to be a forecast of the probability of debt servicing problems.

Communication of the "Weak" categorization outside the context of an analysis of a bank's risk diversification, as is its present use in the examination, may be subject to misinterpretation as to the nature and degree of concern for such exposures. Such communication may be interpreted as outright labeling of countries designated "Weak" as poor credit risks, when the intent is to highlight risk diversification concerns given the potential for debt servicing problems in these countries. As the nature and degree of concern relative to a "Weak" categorization differ from those relative to an "OTRP" designation or to a "Substandard", "Value Impaired", or "Loss" classification, we feel that to change our practice regarding communication of "Weak" categorizations and include them with "OTRP" and classified exposures would not only be a source of confusion to banks, but an inconsistent representation of the meaning of the "Weak" categorization.

5. Recommendation: Request that the Federal Reserve Bank of New York find a better alternative to the present screen.

The present screen of economic indicators, prepared by the Federal Reserve Bank of New York, is used as a preliminary measure of country rankings with respect to the five statistical indicators. The screen is not a primary determinant of final ICERC ratings; rather, it is one of many inputs used in the ICERC review and but one source of input considered when scheduling countries for review. Nonetheless, we will confer with our sister agencies regarding cost effective alternatives to the screen.

6. Recommendation: Ensure that country studies

   - present a consistent framework for evaluating political and social developments, including assessments of internal stability, external security threats, and relations with the United States and other countries;
   - analyse and project key economic variables into the near future;
   - have more intensive and consistent analyses of monetary policy; and
   - discuss whether there is any IMF adjustment program, and if there is, the degree of program compliance.

   The Federal Reserve Bank of New York has implemented a number of changes to the country studies which address this recommendation. We support their continued efforts in this regard.

BANK EXAMINATIONS

1. Recommendation: Develop standards to ensure that examiners consider and document country risk and exposure concentrations in their assessment of capital adequacy.

   Asset quality and risk diversification, including country risk, are a fundamental part of the examination process related to the determination of capital adequacy. The FDIC's Manual of Examination Policies instructs examiners that the determination of the adequacy of a bank's capital begins with a qualitative evaluation of critical variables that bear on the institution's overall financial condition. Assessment of assets, with respect to type, liquidity, and diversification, is one such variable. We are confident that examiners do consider country risk exposure concentrations in their analysis of capital adequacy. Generally, the practice has been for examiners to comment on such situations if they are significant; lack of a specific comment does not imply that no consideration was given to country risk exposure concentrations. In cases where no mention of country risk was made, we would expect that the impact of such lending was not a significant threat to capital adequacy. Likewise, lack of workpaper documentation does not imply that our examiners do not consider country risk in determining capital adequacy. However, in response to the GAO's recommendation, we intend to review our existing procedures and documentation requirements.

2. Recommendation: Require examiners to determine and routinely document banks' compliance with requirements concerning reserves, accounting-for-fees, and public disclosure.

   While we believe that our examiners do carry out these procedures, we intend to review current examination instructions and procedures with respect to these areas.

3. Recommendation: Ensure that examiners review and document the accuracy of country exposure reports.

   We will instruct our examiners to review Country Exposure Reports for accuracy and document their findings.

4. Recommendation: Require examiners to review and document the adequacy of banks' country exposure management systems.

   We believe our examiners do review the adequacy of banks' country exposure management systems and where deficiencies are noted, they are brought to the attention of management. Detailed procedures on the assessment of country exposure management systems are outlined in the "International Operations and Country Risk Examination Procedures" supplement to our examination manual. Nevertheless, we intend to review our procedures and requirements in this area.

5. Recommendation: Develop standards to ensure that examiners highlight "Weak" assets and other exposures that warrant attention in examination reports.

   In its report, the GAO focussed on the inconsistencies noted with respect to highlighting "Weak" exposures. Present examination procedures with respect to country risk have been structured to allow for flexibility and examiner judgement. This is particularly true in determining whether concentrations in certain countries warrant comment, given the composition of the bank's portfolio in the country and the capability of bank management. Examiners point out these exposures as concentrations to highlight given levels of exposures when other elements combine to increase their importance to the overall condition of the bank. Concern regarding inconsistencies in highlighting "Weak" exposures is mitigated somewhat by the fact that a "Weak" designation is a "passed" or non-classified categorization. Nonetheless, we intend to review our outstanding instructions in this regard.

RESPONSE TO SENATOR RIEGLE'S QUESTION FROM
CHAIRMAN SEIDMAN

Question: (Senator Riegle) Well, have there been any cases where the FDIC has said to a state, "You've gone too far?"

Question: (Chairman Proxmire) For the record will you provide the specific instances to the Committee.

Answer:

There is a routine process conducted in the FDIC's Office of Research to monitor new powers that states have authorized for banks. In general, the FDIC does not overrule state law but rather determines on a case-by-case basis whether whatever powers are exercised by banks are exercised in a safe and sound manner.

There have been a few instances where the FDIC has made its objections known to state lawmakers or state banking associations when proposed laws were being considered. We recently objected to a proposal in Massachusetts that would allow banks to amend their by-laws to limit the personal liability of directors. We also have testified before the Kansas legislature, objecting to a proposed law that would prevent the state from closing an insolvent bank for a specified period of time. Our Regional Directors have been urged to let the FDIC position be known during debates of local issues of importance to the safety and soundness of the banking system.

Regarding what kinds of activities should be conducted in a subsidiary, our position in general is described in our study Mandate for Change. We believe that non traditional activities such as certain types of insurance, and securities underwriting, etc. should be conducted in a subsidiary of the insured bank with appropriate regulation and supervision to insure that the bank and the FDIC fund is not exposed to the risk represented by such endeavors.

This general approach is illustrated in FDIC Regulation 337.4 which prescribes the conditions that must be met for bank subsidiaries or affiliates to engage in state authorized securities activities. In sum, the regulation calls for separate operations, management and capitalization as well as adequate disclosure that the entity and its obligations are not covered by FDIC insurance.

In 1985, we also proposed limitations on insured banks engaging in state authorized real estate investment activities. The regulation was not adopted because in part interagency agreement could not be obtained, but the proposal essentially was consistent in approach to Section 337.4 in that real estate activities, over a certain amount would be conducted in a separately capitalized, "bona fide" subsidiary or affiliate. We have now decided to see how banks use this power before we decided whether it should be in a subsidiary or not.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CHAFEE FROM STUART I. GREENBAUM

1. Is it your understanding that were FSLIC to run out of cash, that the next backstop source of funds is the insured thrifts themselves through a special 1%-of-deposits assessment?

This is in response to Senator Chaffee's question about whether "...the next backstop source of funds is the insured thrifts themselves through a special 1%-of-deposits assesment."

This was a possibility former Chairman Gray suggested during the protracted debate surrounding the FSLIC recap. I have no doubt about the legal warrant for the assessment, but its feasibility seems dubious in light of the net worth paucity and the limited earnings capability of the thrift industry. On a trillion dollar balance sheet, the assessment would appear to be a tempting $10 billion, certainly enough to significantly impact the total FSLIC problem, variously estimated between 25 and 65 billion dollars.

However, a large fraction of the trillion in deposits is held by the insolvent and near-insolvent. Thus, much of the $10 billion, perhaps 30 percent, would merely be shifted from one governmental pocket to another.

To be sure, the remaining 7 billion or so would come from what's left of the thrift industry, but two effects should be carefully pondered before pulling the trigger. First, otherwise viable institutions would be subverted. The number is far from obvious, but the precarious state of the industry suggests it would be sizable. Second, by further taxing the already weakened remnants, risk taking incentives are affected in a direction you are likely to find untoward. By stripping away yet another layer of the industry's veneer of capital you weaken risk aversion, which is an indulgence of the secure. Much of the asset quality deterioration we currently bemoan is traceable to the losses sustained by the industry in 1980-1. The predictable risk taking prompted by the suggested assessment is likely to translate into future losses for the FSLIC, or its successor.

Thus, I do not question that FSLIC has a legal claim to the indicated one percent of deposits. As a practical matter, however, I do question whether the assessment represents the "next" backstop, or a backstop at all. The industry's ability to sustain substantial additional taxes is probably quite limited, and it is likely to remain so for the immediate future. Better, it seems to me, to close the insolvent using general funds, reform the deposit insurance system, and then allow a reasonable time to evaluate the result before further altering the regulatory environment. To paraphrase Pogo, we have met the loss, and it is ours!

Sincerely,

Stuart I. Greenbaum
Norman Strunk Distinguished
Professor of Financial
Institutions

SIG:al

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

July 21, 1988

The Honorable William Proxmire
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for the opportunity to contribute additional information for the record. Enclosed with this letter are the responses to questions your committee sent to us following my testimony of May 25, 1988, on the financial condition of the banking industry. Also enclosed is a copy of our study, "Bank Failure: An Evaluation of the Factors Contributing to the Failure of National Banks", which is referenced in the answer to the first question on the causes of bank failures.

Please do not hesitate to let me know if we may be of further assistance to you and your colleagues.

Sincerely,

Robert L. Clarke
Comptroller of the Currency

Enclosures

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM ROBERT L. CLARKE

1. Pathologists have identified a number of causes for bank problems in the Southwest. Some say it's the sour farm and oil economy. Others say it is fraud, noting the high incidence of abuse in some of the failed institutions. Others say it is excessive risk taking, noting that there are plenty of healthy, profitable firms operating under the same poor economic conditions as the failed institutions. Generally speaking, in percentage terms, what role do: 1) the local economy; 2) fraud; and 3) excessive risk-taking play in the ills of banks in the Southwest?

   Secondly, what is the key to success in the Southwest? What course should bankers navigate to avoid future problems?

Last month, the OCC released a study (a copy of which we have included with these responses) of the causes of the failures of 171 national banks during the period 1979 through the end of 1987. We have now updated the analysis we did for that study to include information on the 14 banks that failed between January and April of this year. Hence, we have now done a post-mortem examination of 101 banks in the OCC's Southwestern District--65 in Texas, 29 in Oklahoma, 5 in New Mexico, and 2 in Louisiana.

The following table shows the percentage of those failures in the Southwest in which examiners judged local economic conditions, fraud, and excessive risk-taking to have played a major or contributory role.

Type of Problem [1]	Percentage of Failed SW Banks with: Major Problem	Contributory Problem
Depressed Local Economy	37%	51%
Fraud	11%	29%
Excessive Risk-Taking	71%	[illegible]

It should be noted that our measure of excessive risk-taking has four components. They are: (1) an overly aggressive board of directors (excessively growth-minded and imprudent in its credit views); (2) excessive loan growth in relation to management abilities, controls and systems, and funding sources; (3) overlending relative to borrowers' abilities to service debt; and (4) unwarranted concentrations of credit to borrowers with very similar risk characteristics. The banks judged to have a major problem with excessive risk-taking displayed at least two of those components to a significant degree. Those judged to have excessive risk-taking as a contributory problem displayed just one problem to a significant degree.

Many of the banks in the Southwest that failed had more than one problem. Moreover, many had other major problems that go beyond those cited in the question. Insider abuse was a major problem in 39 percent of the cases and generally poor policies, planning, and management in 91 percent. Only 11 percent had a major problem with a depressed local economy without also having a major problem with fraud or excessive risk-taking. And only 4 percent faced major local economic problems without also having generally poor policies, planning, and management.

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[1] Because several problems may be present in each case, the percentages do not add to 100.

The key to success for banks in the Southwest is good management--avoiding the problems reported in our study. Bankers should not wait for a turnaround in the regional economy because it will take time for changes in the economic environment to be manifested in the performance of banks. The business cycle is a fact of life, and only an involved management, which maintains prudent credit standards, seeks diversification of risks, and adheres to established policies, can build the capital in good times necessary to prepare for the inevitable downturns in the market.

Bank Failure

An Evaluation of the Factors Contributing to the Failure of National Banks

Office of the Comptroller of the Currency
Washington, D.C.

June 1988

Comptroller of the Currency
Administrator of National Banks

Washington, D.C.

Dear Bank Managers and Directors,

Since the beginning of the 1980s, OCC examiners have gained considerable practical experience in dealing with banks that run into problems and, in some cases, ultimately fail.

In order to take full advantage of that experience, and to gain a better understanding of why banks fail, the OCC undertook a detailed study of selected national banks during the last decade. We looked at three groups of banks: those that failed, similarly situated banks that experienced problems but were restored to health, and banks whose condition never deteriorated, despite problems in their local economies.

The results were clear. In most cases, specific factors and patterns of practices within a bank itself ultimately determined its success or failure, although economic problems in the market served by that bank often played a contributing role.

We began this study to help bank examiners identify potential problem areas in banks that otherwise appear to be healthy. But the results are so clear that we believe they will be equally useful to bank managers and directors. I urge you to read this report and its appendices. What you learn about specific management problems and systems may help you strengthen your bank and assure its ultimate success in a period of increasing competition and economic uncertainty.

Sincerely,

Robert L. Clarke
Comptroller of the Currency

NOTE

This booklet was prepared under the general direction of Robert J. Herrmann, Senior Deputy Comptroller of the Currency. Important guidance was provided by Kevin M. Blakely, Deputy Comptroller for Special Supervision, and Susan F. Krause, Deputy Comptroller for Economic Analysis and Strategic Planning.

The project was headed by James E. Horner and Fred C. Graham. Oversight and analysis were provided by Roger W. Burns, David L. Grainger, Bruce E. Ludwick, and Kennard L. Page.

The entire staff of Special Supervision provided valuable support throughout the project. Others within the agency who deserve special mention include: Phillip Battey, Paul E. Chism, Leonora S. Cross, Robert B. Jones, David E. Nichols, Lori Shipman, William Paul Smith, Beverly Slaughter, and Joanne Zaslow.

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INTRODUCTION

In the 1980s, more banks have failed than in the entire previous post-Depression period. These failures have coincided with a period of serious economic decline in certain sectors, most notably agriculture, oil and gas, and commercial real estate. A common presumption is, therefore, that these bank failures have been caused by adverse economic conditions. This presumption is believed to be further borne out by the fact that most failed banks have been located in regions with troubled economies.

This view, though seemingly plausible, is in conflict with the Office of the Comptroller of the Currency's long-held belief that a bank's management and board of directors bear the ultimate responsibility for the performance of their institutions. While the OCC recognizes that the economy plays an important role, examiners also have noted that many banks successfully weather periods of adverse economic conditions.

To understand more clearly the relative roles of external economic difficulties and internal management factors in determining a bank's success or failure, the OCC undertook a study to identify and evaluate the factors contributing to the failure of national banks. The OCC believed that isolating such factors would help it identify banks likely to fail and strengthen its ability to supervise and to help prevent other banks from failing. The study showed that while poor economic conditions make it more difficult for a bank to steer a profitable course, the policies and procedures of a bank's management and board of directors have the greater influence on whether a bank will succeed or fail. In other words, poor management and other internal problems are the common denominator of failed and problem banks.

Management-driven weaknesses played a significant role in the decline of 90 percent of the failed and problem banks the OCC evaluated. Many of the difficulties the banks experienced resulted from inadequate loan policies, problem loan identification systems, and systems to ensure compliance with internal policies and banking law. In other cases, directors' or management's overly aggressive behavior resulted in imprudent lending practices and excessive loan growth that forced the banks to rely on volatile liabilities and to maintain inadequate liquid assets.

Insider abuse and fraud were significant factors in the decline of more than one-third of the failed and problem banks the OCC evaluated. Much of that insider abuse or fraud involved directors, senior management, or principal shareholders or was related to their failure to provide adequate oversight and controls.

Economic decline contributed to the difficulties of many of the failed and problem banks. It was, in fact, a significant cause of problems in more than one-third of the banks we evaluated. Rarely, however, were economic factors the sole cause of a bank's decline. All but 7 percent of the failed and problem banks also had significant internal problems related to management.

This paper presents the findings of our study. It identifies the specific internal weaknesses that appear to be most influential on a bank's failure. It also assesses the primary factors that seem to distinguish banks that fail from those that do not, even in troubled economic environments. The study provides evidence that management and the board of directors, ultimately, are responsible for the success or failure of a bank. It highlights the need for a bank to establish strong policies, controls, and systems when economic conditions are good, thereby greatly increasing its chances of remaining profitable when economic conditions are bad.

DESCRIPTION OF THE STUDY

The OCC's study is based on an analysis of banks that failed, became problems and recovered, or remained healthy during the period 1979 through 1987. The OCC analyzed 171 failed banks to identify characteristics and conditions present when the banks deteriorated.[1] The OCC also evaluated a sample of 51 rehabilitated banks in similar circumstances that experienced significant difficulties from which they recovered. These rehabilitated banks' composite CAMEL ratings moved from a 1 or a 2, to a 4 or a 5, and then returned to a 1 or a 2, during the 1979 through 1987 period.[2] The OCC evaluated these banks to identify characteristics and conditions present when they became problem banks, and again to identify the characteristics and conditions present when they returned to health. Finally, the OCC evaluated a sample of 38 healthy banks that maintained composite CAMEL ratings of 1 or 2 throughout the period. The healthy banks served as a control group against which the OCC compared the groups that experienced problems.

The OCC collected two types of data. First, examiners recorded factual information about each bank's geographical location, asset size, type of ownership, and changes in control. Second, we subjectively evaluated each bank's performance in eight broad categories. The categories were:

1. Policy, planning, and management quality;
2. Audits, controls, and systems;
3. Asset quality;

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[1] The sample includes 94 percent of the banks that, between 1979 and 1987, were declared insolvent by the OCC and on which one of the following actions was taken by the FDIC: a purchase and assumption, a deposit transfer, or a payoff of insured depositors. The 6 percent not included were banks for which sufficient information was not available at the time of the review.

[2] The acronym CAMEL represents the five categories in which banks are rated by examiners—**C**apital, **A**sset quality, **M**anagement, **E**arnings, and **L**iquidity. The composite rating represents the overall status of the bank and takes into account the ratings in all five categories. A 1-rated bank is in the best of health while a 5-rated bank is very near failure. A bank with a composite rating of 4 or 5 is labeled a problem bank by the OCC.

4. Liquidity and funds management;
5. Nonfunding expenses;
6. Insider abuse;
7. Fraud; and
8. Economic environment.

Using examination reports, bank histories prepared by OCC examiners, and other information provided by banks and examiners, the OCC determined the extent to which each rehabilitated and failed bank's performance in a particular category caused it to have problems or to fail. Within each of the eight categories, the OCC evaluated a number of specific characteristics to determine whether each was significantly present, marginally present, or not present. By evaluating these factors, it was possible to detail the particular difficulties and strengths that banks had within each of the broader categories.

Most of the failed banks were smaller banks located in the OCC's Midwestern, Southwestern, and Western districts; that is, 78 percent had less than $50 million in assets. The rehabilitated banks and healthy banks were chosen to conform as closely as possible to the failed banks in terms of location, problems in the economy, and asset size.

WHY BANKS DEVELOP PROBLEMS

The major cause of decline for problem banks continues to be poor asset quality that eventually erodes a bank's capital. The OCC's intent, however, was to determine the factors that were commonly responsible for the poor asset quality. In particular, the OCC wanted to determine the relative importance of internal factors—the banks' management practices—and external factors—the economic environment. To that end, examiners and analysts evaluated the internal and external conditions faced by the three groups of banks in the study.

Internal Problems

Board and Management

The study showed that deficiencies within boards of directors and management were the primary internal problems of problem and failed banks. The quality of a bank's board and management depends on the experience, capability, judgment, and integrity of its directors and senior officers. Several management shortcomings and the problems related to them are discussed below.

(1) Uninformed or Inattentive Board of Directors or Management

The OCC's recently released publication, *The Director's Book*, emphasizes the importance of a bank's board of directors. Specifically,

> "A bank's board of directors is ultimately responsible for the conduct of the bank's affairs. The board controls the bank's direction and determines how the bank will go about its business. . . . A board must be strong, independent, and actively involved in the bank's affairs. The long-term health of the institution depends on it."

Nearly 60 percent of failed banks had directorates that either lacked necessary banking knowledge or were uninformed or passive in their supervision of the bank's affairs. Such deficiencies often arose when the board was not getting sufficient or timely information from management and was not making enough of an effort to correct problems. More than half of the rehabilitated banks had similar deficiencies during their decline into problem bank status. In contrast, none of the boards of the continuously healthy banks or of the rehabilitated banks upon their return to health had deficiencies in these areas.

It is important to distinguish the role and responsibilities of boards of directors from those of management. The responsibilities of the board in directing the bank are:

- to ensure competent management;
- to ensure that appropriate plans and policies are in place;
- to monitor operations ensuring adequate internal controls and compliance with applicable laws and regulations;
- to oversee business performance; and
- to ensure that the bank serves the credit needs of its community.

To fulfill these responsibilities the board should maintain clear lines of authority and accountability and ensure that management understands and carries out the bank's policies. Although the board should leave day-to-day operations (managing the bank) to management, it must retain overall control.

The study showed the following factors, related to poor board or management supervision, to be significant problems for many of the failed banks:

- Nonexistent or poorly followed loan policies (81 percent of the failed banks);
- Inadequate systems to ensure compliance with internal policies or banking laws (69 percent);
- Inadequate controls or supervision of key bank officers or departments (63 percent);
- Inadequate problem loan identification systems (59 percent);
- Decisions made by one dominant individual—*e.g.*, CEO, chairman, or principal shareholder (57 percent); and
- Nonexistent or poorly followed asset and liability management policies (49 percent).

These deficiencies clearly indicate a need for improved oversight on the part of the board of directors and managers. Failure to address problems like these may, in part, be the result of the inability of the board and management to understand important changes in the deregulated financial environment, *e.g.*, risk and return issues as compared to costs of funds.

In general, the study found that rehabilitated banks had similar problems during their decline. Yet, they had somewhat fewer problems with regard to inadequate board supervision of key officers and controls to ensure compliance with policies and laws.

Problem and failed banks consistently lacked policies, systems, and controls to guide their staffs in performing the tasks required to maintain a well-managed and income-producing loan portfolio through both good and bad economic times.

Healthy banks were not immune to some of the characteristics connected with problem or failed banks, although healthy banks never exhibited these factors to the same extent as problem and failed banks. The most frequently identified characteristics related to one dominant decision maker and inadequate systems to ensure compliance with internal policies and banking laws.

(2) Overly Aggressive Activity by Board or Management

Another set of problems that prevailed in failed banks was overly aggressive activity, described as excessively growth-minded or following liberal credit views. Aggressive, growth-minded behavior is not, in and of itself, a weakness. In fact, an aggressive approach combined with well-established policies and controls can be a successful strategy. What the OCC found to be a problem, however, was *overly* aggressive or *excessively* growth-minded actions relative to the circumstances in which the bank operated. In 42 percent of the failed banks, the board of directors was aggressive in a way that had a significantly negative effect on performance.[3] In fact, eight of every 10 failed banks were judged to have had a board or management that was overly aggressive to some degree. The lending and operating practices of many of these banks also reflected problems. For example, failed banks frequently exhibited:

- Inappropriate lending policies: liberal repayment terms, collection practices, or credit standards (found in 86 percent of the failed banks);

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[3] Note that an aggressive board can also be an uninformed or inattentive board. It can emphasize growth and aggressive income generating policies without monitoring or even knowing the particular activities of its management.

- Excessive loan growth in relation to the abilities of management staff, control systems, or funding sources (51 percent);
- Undue reliance on volatile liabilities—*e.g.*, deposits greater than $100 thousand, but not necessarily brokered (41 percent); and
- Inadequate liquid assets as a second source of liquidity (38 percent).

During their decline, the rehabilitated banks also experienced problems associated with overly aggressive behavior, but less frequently than the failed banks did. Only 22 percent had a board that examiners judged to be significantly overly aggressive, and fewer than 50 percent tended to be overly aggressive to any degree. Moreover, declining rehabilitated banks had fewer significant problems with excessive loan growth, reliance on volatile liabilities, and inadequate liquid assets. In spite of their more conservative behavior relative to that of the failed banks, 96 percent of the rehabilitated banks still had some form of inappropriate lending practices during their decline. The problems associated with liberal lending practices were apparently less detrimental when accompanied by a less aggressive lending philosophy.

Among the healthy banks, overly aggressive behavior was nearly nonexistent. Rehabilitated banks, after their return to health, also had no significant problem with any of the characteristics we have associated with overly aggressive behavior. This evidence shows that overly aggressive behavior may well underlie severe problems and make recovery from those problems much less likely.

(3) Problems Involving the Chief Executive Officer (CEO)

The CEO is probably the most important determinant of the success or failure of a bank. The study's results indicate how important the CEO is by showing that CEOs had significant weaknesses at many of the problem banks. Sixty-three percent of the failed banks had CEOs that clearly lacked the capability, experience, or integrity necessary to make their banks successful. Another 18 percent had CEOs who showed some signs of weakness in these areas. In the declining rehabilitated banks, CEO problems were less often significant; still, 39 percent had significant problems, and another 39 percent had marginal shortcomings.

The CEOs at the healthy banks were generally judged to be strong. Those at continuously healthy banks had no apparent problems with experience, capability, or integrity. Likewise, those at recovered banks had no significant problems in these areas. Clearly, choosing a strong CEO is an important step in ensuring a bank's success.

(4) Other Problems Related to Oversight or Management Deficiencies

Other indications of either overly aggressive activity or uninformed management decisions included:

- Excessive credit exceptions—*i.e.*, missing financial statements or income information about borrowers or poor collateral documentation/perfection (found in 81 percent of the failed banks);
- Overlending—*i.e.*, high loan amount relative to debt service ability of the borrower (72 percent);
- Collateral-based lending and insufficient cash flow analysis (13 percent); and
- Unwarranted concentrations of credit to one industry (36 percent).

We found these factors, in nearly identical percentages, in the rehabilitated banks during their decline.

Surprisingly, excessive credit exceptions were found in a high percentage of healthy banks, especially in those that were continuously healthy. This behavior was apparently not as damaging when other lending practices are well-conceived and executed.

Insider Abuse and Fraud

The study found insider abuse in many of the failed and rehabilitated banks during their decline. Insider abuse—*e.g.*, self-dealing, undue dependence on the bank for income or services by a board member or shareholder, inappropriate transactions with affiliates, or unauthorized transactions by management officials—was a significant factor leading to failure in 35 percent of the failed banks. About a quarter of the banks with significant insider abuse also had significant problems involving material fraud. Material fraud, in fact, played a significant role in 11 percent of the failures. During their decline, 24 percent of the rehabilitated banks experienced significant insider abuse, but none were seriously affected by material fraud.

Healthy banks, in contrast, generally avoided problems in these areas. Those that had recovered from problem bank status had corrected even their marginally apparent insider abuse and fraud problems. Of the continuously healthy banks, one had a marginal problem with fraud and another with insider abuse.

Problems of insider abuse and fraud were often related to the lack of oversight and controls. Several conditions, found more often in failed banks that experienced significant insider abuse and fraud than in failed banks that did not, may have provided the opportunity for such problems to become significant. Inadequate supervision of key officers, a dominant decision maker, unwarranted concentrations of credit to one industry, out-of-area lending, and inadequate guidelines for purchasing loan participations all appeared as significant conditions substantially more often in the failed banks with significant insider abuse or fraud than in other failed banks.

Generally, these conditions, with the exception of a bank's reliance on one dominant decision maker, were at worst marginally apparent at the healthy banks. About one in four of the continuously healthy banks had marginally unwarranted concentrations of credit to one industry, but fewer than 10 percent of the healthy or recovered banks had any of the other characteristics mentioned above. Apparently, proper supervision of bank officers and formal guidelines to monitor and control lending practices also helped to limit insider abuse and fraud.

External Factors—The Economic Environment

Seventy-three percent of the failed banks operated in significantly depressed economic conditions, while another 15 percent faced marginally depressed conditions. These depressed conditions usually resulted from the deterioration in the agricultural, oil and gas, or commercial real estate economies. Simply operating in depressed local economies does not, however, imply that a bank's failure is largely the result of the economic conditions. The study did show that an adverse economy was a significant factor in 35 percent of the failures. Even so, a depressed economic environment was the sole significant cause of failure in only 7 percent of the banks surveyed. The remaining failed banks that operated in depressed economies had significant internal problems as well.

The evidence from healthy and rehabilitated banks also supports our hypothesis that economic conditions are rarely the primary factor in determining a bank's condition. Fifty-nine percent of the rehabilitated banks and half of the healthy banks operated in significantly depressed economies. In fact, the study showed that economic conditions played a significant role in the decline of a larger percentage (39 percent) of the rehabilitated banks than of the failed banks. While many of the rehabilitated banks were assisted in their recovery by improving economic conditions, they also made the necessary managerial changes to promote recovery. Sixteen percent of the rehabilitated banks recovered in spite of operating in local economies that remained significantly depressed. Another 67 percent faced marginally depressed economic conditions during their recovery. Without the improvements in management, controls, and systems, these banks would have been far less likely to benefit from improvements in their economies.

WHY SOME BANKS RECOVER WHILE OTHERS FAIL

A number of factors may contribute to a problem bank's recovery. These include:

- changes in management;
- improved banking practices;
- changes in banking philosophy;
- capitalization; and
- improved local economic conditions.

In spite of the few lingering problems found at rehabilitated banks, their efforts to make important changes were clear. At the directorate level, changes in knowledge, involvement, and philosophy were evident. The OCC judged the boards of nine of every 10 recovered banks to be very active in overseeing the operations of their institutions. Although rehabilitated banks were not the victims of overly aggressive boards to the extent that failed banks were, all of those that did have this problem made appropriate adjustments. Furthermore, when the OCC's evaluation revealed a CEO who lacked ability or integrity, 90 percent of the rehabilitated banks replaced the CEO, while 76 percent of the failed banks did so.

The fact that rehabilitated banks, during their decline, were less likely to have an overly aggressive board of directors or to follow practices that might be deemed overly aggressive also worked in their favor. The study showed that overly aggressive behavior—undue emphasis on growth—is apparently a very risky strategy, largely because it leaves the bank exposed when the economy turns against it. If the growth takes place in a sector that is experiencing a speculative boom, for example, a downturn can be sudden and severe. Overly aggressive lending under such conditions may underlie a more rapid erosion of a bank's net worth and make recovery less likely.

Another important factor is that, relative to failed banks, rehabilitated banks had a much better record of compliance or partial compliance with ad ministrative actions (*e.g.*, a memorandum of understanding, a formal agreement, a cease and desist order) taken by the OCC. The OCC took administrative actions in roughly similar percentages with the failed and rehabilitated banks. OCC examiners, however, judged rehabilitated banks to be in compliance or partial compliance with administrative actions that were in place at the time of bank examinations 86 percent of the time. They judged failed banks to be in compliance or partial compliance only 41 percent of the time.

The failure to comply with these regulatory actions does not simply mean that a bank was unable to change its financial situation. Rather, such failures imply that the banks did not make a serious or competent effort to meet the directives contained in the administrative action. Generally, even failed efforts are considered to be partial compliance ("meeting the spirit" of the action), and isolated exceptions to the letter of the action do not necessarily result in a judgment of unacceptable compliance.

Another factor that obviously affected a bank's ability to recover from difficulties was its capitalization. Capital serves as a buffer between operating losses and insolvency. The more capital a bank has, the more losses it can withstand. In other words, a bank's capitalization determines the amount of time it has to correct internal weaknesses or to outlast negative external influences. Whether a problem bank fails or recovers will often depend on the time it has before its losses completely dissipate its capital.

The OCC found that investors injected an average of $950 thousand in new capital per rehabilitated bank but only an average of $300 thousand per failed bank. Although the larger injections of capital into the rehabilitated banks may simply reflect the investors' "deep pockets" or their perception that these banks offered a better investment opportunity (*i.e.*, they were prospectively viable), they undoubtedly bought more time for the banks to complete their recoveries.

While a banker's job is undoubtedly easier in a strong economy, strong management and systems can prevent failure and promote recovery even during difficult economic times. Management and the board of directors must act positively to implement such controls and systems if they intend to safeguard the shareholders' capital over the long run. The evidence in the study shows that attention to and compliance with administrative actions taken by bank supervisory agencies have a positive impact on a bank's condition.

WHY SOME BANKS STAY HEALTHY

The 38 healthy banks in the OCC sample were not free of managerial shortcomings or externally generated economic problems. As mentioned above, we chose the healthy banks so that 50 percent of them faced a significantly depressed economic environment. The OCC's analysis shows that these banks generally had fewer internal difficulties than the banks in the other groups. In fact, none of the healthy banks that operated in depressed economies had significant problems in any of the other broad categories previously mentioned. Moreover, only six had significant difficulties in more than three of the numerous specific, underlying areas of concern. This evidence, along with that from the failed and rehabilitated banks, confirms the OCC's belief that the best way for banks to weather an economic storm is to minimize internal shortcomings. A strongly managed bank with adequate systems that are in place and followed is best prepared to remain profitable through both good and bad economic times.

The healthy banks had many fewer managerial problems than the banks in the other groups. Without exception, examiners judged board supervision and general management behavior from the CEO down to have posed no significant problem for these banks. Rather, the CEO and other officers in the healthy banks showed significant strengths in their diverse backgrounds and experience in banking matters.

Officer and staff positions below the CEO level also appeared to have had an impact on a bank's success. The study noted a much higher level of overall management diversity and experience in healthy banks than in problem banks. Further, an assessment of the adequacy of officers and staff (number, tenure, turnover) showed healthy banks to be in a much better position than failed or problem banks; 92 percent of the healthy banks received very high marks for this characteristic compared to only 15 percent of failed banks. These statistics highlight the importance of capable, consistent support staff below the senior management level.

None of the healthy banks in the OCC sample experienced any significant insider abuse or fraud.

Although the healthy banks were not completely without weaknesses, their weaknesses were generally isolated and offset by strengths in other areas. The way to maintain a bank's health, therefore, appears to be to limit the number of shortcomings of management, the board of directors, and the policies and systems they put in place.

CONCLUSION

The study identified, through the evaluation of failed, rehabilitated, and healthy banks, the difficulties and conditions that result in problem and failed banks. Examiners and analysts focused on the relative importance of external economic factors and internal managerial factors. The study found that internal factors can have a great influence on the extent to which an adverse external environment harms the bank. The OCC sample includes banks that failed in reasonably good, as well as in bad, economic environments. It also includes banks that recovered from problems, and others that remained healthy in bad economic environments. The difference between the failed banks and those that remained healthy or recovered from problems was the caliber of management. Banks succeeded by establishing and adhering to policies that would see them through both good and bad economic times. While the managements of these banks were not without problems, they tended to have problems in fewer areas, rather than difficulties in all areas as did most of the failed banks.

To get a better idea of how the healthy banks remained healthy in spite of poor economic environments, the OCC interviewed several of the banks' chief executive officers and board chairmen. The bankers who were interviewed each played an active role in overseeing a successful bank in an economically depressed region. Their comments support the results of the OCC's evaluation.

Without exception, they emphasized the importance of an active and involved board of directors. They said the board and management should work together within well-specified roles to establish realistic goals and a strategic plan for the bank. In other areas, the interviews revealed that these bankers generally had a well-conceived banking philosophy. They had formal, written policies in place. They kept lending limits low for all bank officers from the CEO down. They established clear rules for documentation, collateral, and other lending procedures, and compliance was monitored through well-established review processes. Perhaps most important, given the troubled economic regions in which they operated, these bankers emphasized profitability and conservative lending, even at the expense of growth. Each of the bankers interviewed pointed to the overly aggressive pursuit of growth, especially among recently established banks, as a major weakness in the troubled banks in their areas.

The opinions of these bankers, supported by the success of their banks, and the study's conclusions, supported by the OCC's analysis, clearly point to management shortcomings and inadequate board supervision as the critical cause of bank failure.

Some might argue that the same internal weaknesses exist in many viable banks that operate in very healthy local economies, and they, undoubtedly, would be correct. But that is not really the issue. Banks are not in a position to exercise any great influence on the external conditions they face. They are, however, in a position to change their internal operating procedures. One thing is certain: external conditions will continue to fluctuate. The OCC study demonstrates that banks are able to remain healthy institutions throughout the fluctuations by establishing and maintaining strong internal policies, systems, and controls. Without such policies they are more likely to succumb to the external fluctuations. Problem and failed banks are almost never simply the result of depressed economic conditions. In the evolving business of banking, successful bankers must understand the risks of the businesses in which they are engaged, ensure the expertise of their board and management, and establish the operating capability to handle the products and services they offer.

APPENDICES

Appendix A—TABLES

Descriptive Characteristics of the Surveyed Banks

Banks by Asset Size:

	Percent of		
Asset Size in $	Failed Banks	Rehabilitated Banks	Healthy Banks
0–15 million	30	16	13
16–30 million	34	41	26
31–50 million	15	14	24
51–100 million	12	17	29
100MM–1 billion	8	12	8
Over 1 billion	1	0	0

Bank Location by OCC District:

	Percent of		
OCC District	Failed Banks	Rehabilitated Banks	Healthy Banks
Northeastern	3	2	0
Southeastern	4	2	0
Central	8	16	18
Midwestern	15	37	24
Southwestern	52	35	45
Western	18	8	13

Banks Operating in Depressed Local Economies

	Percent of Banks in Significantly Depressed Economies			
	Failed Banks	Rehabilitated Banks		Healthy Banks
		Before recovery	After recovery	
Operated under depressed economic conditions	73	59	16*	50
Agricultural	22	41	8	3
Mixed agricultural and oil and gas	15	4	0	5
Mixed agriculture and commercial real estate	0	0	2	0
Oil and gas	15	4	5	16
Mixed oil and gas and commercial real estate	3	2	0	11
Commercial real estate	14	2	2	16
Other	4	6	0	0

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*Another 67 percent of the rehabilitated banks operated in marginally depressed local economies after their recovery.

Eight Broad Categories Where Weaknesses Had A Significant Impact on Decline

Categories	Percent of-Banks with Significant Weaknesses	
	Failed Banks	Rehabilitated Banks (Before recovery)
Policies, planning, and management	90	88
Audits, controls, and systems	25	24
Asset quality	98	98
Liquidity and funds management	10	6
Nonfunding expenses	9	4
Insider abuse	35	24
Material fraud	11	0
Economic environment	[illegible]	39

Corrections of Management-Driven Weaknesses Were Important in the Recovery of the Rehabilitated Banks

Characteristic	Rehabilitated Banks					
	Declining Condition			Improving Condition		
	No	Moderately True	Yes	No	Moderately True	Yes
Poor judgement in decision process	14%	28%	50%	88%	12%	0%
Inadequate management, officers, or staff	22%	29%	41%	67%	31%	0%
Inadequate controls of key officers or departments	31%	24%	41%	94%	6%	0%
Inadequate or failed to follow loan policy	4%	16%	80%	65%	35%	0%
Inadequate problem loan identification system	2%	16%	82%	65%	31%	4%
Excessive growth relative to management, staff, controls, systems, funding	61%	18%	22%	100%	0%	0%

Problem and Failed Banks Lacked Important Management-Driven Strengths

Strong Policies, Controls, and Systems

Condition	Significant Positive Condition			
	Improving Banks	Healthy Banks	Failed Banks	Declining Banks
Systems to ensure compliance with policies and law	67%	45%	6%	10%
Loan policy	65%	50%	4%	4%
Controls over key bank officers or departments	94%	87%	16%	31%
Problem loan identification system	65%	58%	9%	2%
Management information systems	77%	71%	18%	26%

Loan Portfolio Management Practices are Important Determinants of Asset Quality

Characteristic Present	Healthy Banks			Failed Banks		
	No	Moderately True	Yes	No	Moderately True	Yes
Liberal lending practices	84%	13%	0%	2%	10%	85%
Excessive growth relative to management, staff, systems, funding	84%	13%	3%	24%	22%	52%
Overlending	79%	11%	0%	5%	12%	73%
Collateral-based lending	60%	32%	3%	8%	27%	55%
Unwarranted Concentrations of Credit	76%	24%	0%	34%	22%	37%
Out-of-area lending	88%	5%	3%	41%	15%	23%
Excessive financial statement exceptions	37%	34%	29%	3%	16%	79%
Excessive collateral documentation exceptions	52%	39%	0%	5%	22%	67%

Distinguishing Features of Failed and Problem Banks with (and Without)* Insider Abuse and/or Fraud

	Percent of Banks with Significant Problems	
Specific Condition	Failed Banks	Rehabilitated Banks (Before recovery)
Decisions made by one dominant individual	74 (46)	67 (46)
Management behavior negatively affected an affiliate relationship	31 (6)	25 (3)
CEO of poor integrity	70 (21)	58 (8)
Inadequate supervision of key officers	79 (52)	58 (36)
Out-of-area lending	39 (4)	42 (8)
Inadequate guidelines for purchasing loan participations	31 (12)	8 (8)
Unwarranted concentrations of credit	49 (28)	17 (26)

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*The number without parentheses is the percentage of banks with insider abuse or fraud that also had the particular characteristic. The number in parentheses is the percentage of banks without significant insider abuse or fraud problems that had the particular characteristic.

Administrative Actions with Problem Banks

Action Taken (*)	Rehabilitated Banks	Failed Banks
Memorandum of Understanding	12%	14%
Formal Agreement	47%	46%
Cease and Desist Order	69%	75%

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*Percentages do not add to 100 because more than one action may have been taken against a particular institution.

Degree of Compliance with Administrative Actions

Compliance	Rehabilitated Banks	Failed Banks
Acceptable	45%	6%
Partially Acceptable	41%	35%
Unacceptable	14%	59%

Appendix B—GLOSSARY OF TERMS

Summarized below are definitions of many of the terms/characteristics used in this paper. For each sample bank, scores were assigned to reflect the relative degree of presence or absence of these conditions.

Board of Director and Senior Management Characteristics

Board Lacks Necessary Banking Knowledge: Board members who fail to understand their responsibility to set policy and institute ways to measure management's performance. Directors who lack business experience or do not understand general banking procedures. For example, board members have a poor understanding of various areas such as funds management, proper documentation for the types of loans being made, or proper control systems. The board may have approved or ignored situations or transactions which a knowledgeable director could be expected to question.

Board Uninformed of Bank's Operation/Passive Board: These are two distinct concepts, but are scored together because the effects are the same. An uninformed board may not receive good reports on which to base decisions. This could be a lack of reports or too many detailed reports hindering the ability to see trends or the larger picture. An uninformed board may be shielded from needed information by management. A passive board tends to be dominated by management or one or two members. While they may or may not be well informed, they defer to the leadership of management or a particular member without much dissent. Passive boards tend not to question or are easily convinced that a particular situation or transaction is normal, legal, or desirable.

Overly Aggressive Board: A board that sets growth or income as a prime goal to the detriment of asset quality standards or funding sources. A board may be aggressive by being liberal in credit views although they may also be passive, uninformed, or lack banking knowledge. An overly aggressive board seeks growth or profits without first properly ensuring that stable funding is available or that credit standards and controls are in place to minimize undue risk.

Decision-Making Process Lacks Proper MIS: Board/management does not have appropriate reporting systems to identify key trends, problems, asset quality, etc. Board/management reports may exist but may be inaccurate, lack key information, or be too detail oriented.

Poor Judgment in Decision-Making Process: This data element is intended to reflect instances where the board has simply made bad decisions in key areas which are not the apparent result of divided loyalties. A high rating for this element would ordinarily reflect a board and management that had reasonable access to information upon which to act but ignored that data or for other reasons made poor choices.

Decisions Made by One Dominant Individual: A bank where one person is clearly dominant with little room for opposing opinions or discussion. Often this person also holds a large block of stock. The individual may be unable to delegate and may be involved in too many routine decisions to see the larger picture or may be too strong willed to recognize errors or risks in his/her decisions. This element is not always negative, however. A dominant individual could be a very good manager. This element scores the existence of a dominant person, not its effect.

CEO Lacks Experience/Capability: New CEO, untested, with limited or overly specialized experience as opposed to executive management experience in a bank environment. A CEO whose ability, judgment, training, or personality limits his capability to perform effectively as an executive officer of a bank. An example could be a CEO who just cannot say "no" or one who does not understand fundamental credit analysis.

CEO of Poor Integrity: A CEO who has divided loyalty or who has engaged in self-dealing or fraud. A CEO who places his personal financial dealings before the bank's. A CEO who may have lied to the board or examiners or who has difficulty in recognizing unethical conduct.

Management Team: Lack of Diversity and Breadth of Experience: (Qualitative assessment) A management team with limited training or experience for the types of business conducted. A management team that is less than fully competent for the situation. For example a management team could have many years' experience but it may be all in the same bank using out-dated methods. A quality management team must be able to evolve, to keep up with a changing industry, etc.

Inexperienced/Inadequate Management/Officer/Staff Other than CEO: (Quantitative assessment: number, tenure/turnover, etc.) Simply trying to do too much with too few people. A bank with high turnover in key areas. A small bank with only two officers trying to do the work of three or more.

Inadequate Controls/Supervision of Key Officers/Departments: Poor control or supervision of key areas. The CEO or board has failed to properly evaluate or review the work of certain areas. For example, a senior loan officer may be essentially unsupervised due to tenure and the trust placed in that officer by the board. This individual may initiate a large number of poor quality transactions before anyone is aware of the risks the officer is taking. Another example could be an investment officer who commits the bank to a large volume of inappropriate investments without management and the board consciously approving that strategy.

Inadequate Policies or Failure to Follow Policies (Loan; Investment, Asset/Liability Management [or funding], Concentrations [of assets]; Conflict of Interest): A bank which does not have such policies; where such policies are inadequate to guide officers in the types of business the bank was involved in; or where the board fails to require compliance with all or part of the policy. An example of this could be a bank where the board has adopted policies in all of these areas but where the policies are kept in the board minutes only. The policies are not actually used by officers to guide their decisions, and the board rarely, if ever, actually reviews or tests compliance with the policies. Thus, the board may have gone through the perfunctory exercise of adopting policies, possibly only to placate regulators.

Audits, Controls, and Systems

Inadequate Controls/Systems to Ensure Compliance with Policies and Law: Where a bank fails to have a system of checks and balances to ensure officers or employees operate within board policy and that transactions comply with law.

Inadequate Problem Loan Identification System: The board and management should be continuously aware of those loans which have deteriorated, need additional documentation, or have higher than normal risk. This should be accomplished by some form of internal loan review which identifies and reports such loans for board and executive review and action. A bank with no problem loan list or one that does not adequately measure risk or trends in the portfolio would have an inadequate problem loan identification system.

Asset Quality Management

Excessive Financial Statement Exceptions: A large number or dollar amount of loans which are not supported by current financial information on primary obligors or guarantors appropriate for the type of loan. Management should have sufficient information to make an informed credit decision regardless of the type of credit. In general, if exceptions total more than 7 percent to 10 percent of total loans, this item would be scored. However, a critical score would generally indicate more than 10 percent exceptions (15% to 20% or more) or significant exceptions in key loan departments or types of loans. Credit exceptions include such things as lack of a current balance sheet, income statement, or a cash-flow analysis for loans to be repaid from operations of the business.

Poor Collateral Documentation/Perfection: Significant overall level of collateral exceptions or significant exceptions in a particular type of loan. Collateral exceptions include failure to record liens, improperly filed liens, failure to inspect collateral, failure to perform lien search, failure to obtain loss payee clause on appropriate insurance, failure to obtain reliable appraisals, failure to control collateral, etc. Scoring for this data element is not as closely tied to percentages of the portfolio as financial statement exceptions.

Liberal Terms/Failure to Enforce Repayment (Inadequate collateral/capitalized interest): Where a bank makes loans with repayment terms that are indeterminate, bear no relation to the purpose of the loan (*i.e.*, 10 year loan on equipment with expected life of five years), or are otherwise more liberal than would be expected for a given loan type. Failure to enforce repayment can include simply allowing customers to ignore payment terms. It can also include loans where payments are extended or the loans renewed frequently without requiring significant paydown, particularly if interest is added to the new loan from the old loan. Liberal terms, the failure to recognize problem situations, and postponing recognition of problems through renewals may result in the board's having a false sense of security. This could lead the board to take actions which would not be prudent if the true condition of the bank's loan portfolio were known.

Excessive Loan Growth in Relation to Management/Staff Abilities, Controls/Systems, Funding Sources, etc: In order for a bank to increase loans successfully, it must have a sufficient number of skilled officers and employees to handle the work load created by making the loans and also by monitoring and servicing the loans thereafter. The bank must also have sufficient funds (deposits, borrowings, or capital) to make loans. Losses can occur through narrowed or negative interest spreads if the bank's loan growth is funded by incurring a large amount of interest-rate risk (to add to the credit risk of the new loans) through borrowings or high cost, volatile deposits. Liquidity problems can also develop if available funding sources contract.

Out-of-Area Lending: If a bank makes loans to borrowers who are not in its normal trade area, the bank's ability to properly evaluate the loan and to monitor and service it is diminished. A normal trade area is the area where the bank makes most of its loans and receives most of its deposits, and in which it has a good understanding of the economics and practices. Many banks routinely have a few out-of-area loans to former area residents or affiliates of local businesses, etc. Where a borrower resides or conducts business is not the main issue. The key is whether or not the bank knows the customer and whether the bank can monitor the credit.

Overlending: High Loans to Debt Service Ability: Often occurs in tandem with liberal terms/renewals. Loans based on no or inadequate analysis of the borrower's actual capacity to pay. For example, making loans to a particular farmer because he has a large number of highly productive acres rather than actually determining if he can service the additional debt. Overlending includes character lending. Such loans are based on officer or board personal friendships or long-time associations with a customer, his good standing in the community, or reputation rather than the customer's ability to pay. It is assumed he can pay because he's a good farmer or a good person, or has always paid before. A large net worth or equity in a business or farm does not necessarily mean a customer has the cash flow to make required payments.

Collateral-Based Lending/Insufficient Cash-Flow Analysis: This item scores the bank's reliance on collateral values (or assumed collateral values) rather than ability to pay. This practice is often believed to be safe and conservative because the bank always has collateral. However, without an analysis of the customer's ability to pay, the bank is in a sense volunteering to buy the collateral. The collateral may decline substantially in value (*e.g.*, oil prices, farm land values), or the bank may fail to obtain a reliable appraisal of the collateral. When the bank does take the collateral, it often turns out to be worth less than the loan or is illiquid. This is particularly true if the collateral is specialized in nature.

Inadequate Loan Participation Purchased Guidelines: Although stated as a policy issue, the scoring of this item also reflects practice and procedures. Loans purchased (participations) from another institution may be out-of-area and are originated by another bank. The other bank usually retains the responsibility to service the loan. Thus, the buying bank often has little actual control over the credit and is usually not part of the initial negotiation of terms or evaluation of the loan proposal. Since the buying bank is exposed to more risk than on the direct loans it makes, such loans should be evaluated, documented, and monitored at least as well as direct loans made by the bank. A high rating for this element indicates a bank which has accepted poorly documented, high risk, poorly structured, poorly monitored, or out of area loans and without doing a good job of evaluating the credit themselves before buying or monitoring thereafter.

Unwarranted Concentration of Credit: A concentration of credit is a high volume of assets with very similar risk characteristics. A concentration is generally defined as more than 25 percent of total capital. Examples of concentrations are loans to one industry; loans to one group of companies or affiliated businesses; loans secured by the same type of collateral (soybeans, oil production); or out of area loans. Concentrations have a high level of risk for the bank because they amount to having all of the bank's eggs in one basket. For example, if oil prices go down, suddenly all oil production loans could be in trouble. It is normal for many community banks to have high concentrations related to local economic bases. For example, banks in rural areas will have a large portion of assets invested in farm loans and farm-economy dependent businesses. An *unwarranted* concentration is where the bank allows a concentration that it does not have to permit (*e.g.*, making loans to one group of affiliated companies or loans dependent upon the price of one commodity) rather than ensuring good diversity.

Asset/Liability Management

Reliance on Volatile Liabilities ($100M and greater certificates of deposit, not necessarily brokered): This element scores the extent to which a bank has relied on this volatile funding source to support assets; is related to failure to develop sufficient core deposits, but is different in that it focuses on the substitute for core deposits; considers the strategy of funding through the most volatile deposits. This type of funding may be used to support growth or replace other funding contractions, such as a decline in core deposits, which creates undesirable mismatches in maturities and interest-rate sensitivity.

Inadequate Liquid Assets/2nd Source of Liquidity: This element scores the bank's ability to convert assets to cash without sizable capital losses or to borrow sufficient sums to meet its needs. Such needs can include funding asset commitments, paying matured or withdrawn borrowings, or funding deposit contractions. A bank's primary sources of liquidity after cash equivalents are the investment portfolio and borrowings. If the market value of the bank's investments is below book value, the bank would realize a loss on the sale of such assets. Similarly, because of a bank's reputation or financial condition, lenders may not be willing to lend money to the bank. It is important to note that for this study, the data elements are scored based on the bank's initial liquidity problems. As problem banks become critical and fail, liquidity problems often become much more severe. Liquidity at failure is not scored here.

Insider Abuse

The term, "insider" refers to principal shareholders, directors, executive officers, and other officers or staff who, through their position, are able to influence operations or decisions within a bank. Insider abuse is a general term that encompasses various activities which may or may not be lawful. While an abusive situation usually violates one or more banking laws or regulations, legal violations are not a necessary element. Insider abuse includes the broader range of actions where an insider takes action or fails to take action; where the bank is harmed, takes on additional risk, or loses an opportunity; and where the insider or a related party somehow benefits because of the insider position.

Self-Dealing: This is a term used to encompass those situations in which an insider's interest is placed above the interests of the bank or where insiders use their position or authority to grant loans or conduct other transactions for personal benefit or the benefit of relatives or related business interests. This can encompass many types of situations. One of the most common forms of self-dealing involves making loans to oneself and related businesses at preferential terms and/or with lowered underwriting standards for the purpose of making a profit in the side business.

It is not necessary that the person actually process the paperwork involved in such transactions; more important, the transactions must occur on the authority of insiders. Self-dealing can describe a single bank executive authorizing transactions for himself or various officers and directors approving transactions for each other. Self-dealing situations usually violate one or more regulations or statutes, but the term is sufficiently broad as to include situations where the transactions may be technically lawful but exhibit bad judgement or self-interest above the interests of the bank.

Board/SH (principal shareholders) Dependence on Bank for Income/Services: This element is similar to self-dealing in that directors and shareholders may have a number of transactions with the bank. However, when such transactions are handled at arms length with the full knowledge of disinterested directors, present no unusual additional risk to the bank, and are lawful, they are usually not considered self-dealing. This element is intended to score those situations where directors and shareholders may not be considered to be self-dealing but they become dependent upon the bank for income and services. This may occur through overlending or adverse trends in the interested party's business. For example, a director may start out as one of the bank's best customers, but, for whatever reason, reaches a point where he is dependent upon the bank for services and thus may no longer be able to make objective decisions as a director. He may develop divided loyalty or be much less willing to take action on other problem bank assets lest his own transactions be similarly treated.

Inappropriate Transactions with Affiliates: Affiliates are businesses or relationships which, due to common ownership, directors, or influence, are tied closely to the bank. This element scores the extent to which unlawful or detrimental transactions have occurred with affiliates.

Unauthorized Transactions by Management Officials: This data element scores transactions in which a manager has executed transactions for his or a related interest's benefit without full knowledge and authority from the board. It also may involve transactions which do not benefit the manager directly, but were not within the manager's authority or were done without board knowledge of what the manager was doing. For example, sometimes bank management disagrees with a board decision or is afraid to inform the board of a particular situation. An officer then acts on his own.

Fraud

Material Fraud: This element is intended to score situations where significant fraud has been discovered or is strongly suspected by examiners. Ordinary teller losses, etc., are not scored here. Material fraud generally includes the intent to deceive and/or an attempt to conceal. A high score would be attributed to this element if the fraud was large in relation to the bank's capital or was otherwise a significant factor in the deterioration of the bank.

2. The banking industry faces some of the same woes as the thrift industry in the Southwest. To tackle that problem, FSLIC Chairman Danny Wall has proposed an ambitious plan to consolidate the number of thrifts through a number of mergers. What are your views of this plan? What are its advantages and disadvantages? Should a "Southwest Plan" be adopted for the banking industry?

The thrift industry and the commercial banking industry face common regional economic problems in the Southwest, but the problems facing the thrift supervisors differ fundamentally from those facing the supervisors of Texas banks.

The basic problem currently facing thrift supervisors is the timely disposition of a large backlog of insolvent institutions. This backlog has accumulated over a number of years for a variety of reasons, including the delay and shortfall in providing adequate resources to the FSLIC fund to permit the timely closing of insolvent institutions. The partial recapitalization permitted by the Competitive Equality Banking Act, passed in August 1987, will permit the FSLIC to address only part of its caseload of insolvent thrifts.

We have not had detailed information about the "Southwest Plan" as it has evolved. However, as we understand it, the plan is designed to allow the FSLIC to catch up with the backlog, using a large-scale application of one method of addressing insolvencies--assisting viable thrifts to acquire and consolidate groups of insolvent thrifts. These assisted mergers are intended to achieve the elimination of insolvent institutions and an improvement in the efficiency of the industry.

The advantages of the plan are that it is expected to reduce the competitive pressures to pay high deposit rates, to reduce operating costs through consolidations, and to demonstrate to the market that the FHLBB is willing and able to take decisive action.

A banking industry plan comparable to the "Southwest Plan" would provide no advantages over the current approach to handling bank insolvencies. Bank supervisors have resolved a smaller number of insolvencies individually, as they have occurred, and will be able to continue to do so. In 1987, bank supervisors closed 182 commercial banks, but the size of the FDIC insurance fund increased slightly, even after establishing reserves of about $1 billion to cover the expected costs of the First City Bancorp resolution. In 1988, the FDIC expects to be able to deal with another record number of case resolutions. The FDIC anticipates that it may experience a loss for 1988, but it expects this to be a one-year aberration. And, in any event, the magnitude of the potential loss is not expected to reduce significantly the net assets of the FDIC.

3. Is it prudential banking practice to encourage banks to re-lend and re-lend to cover interest payments?

What are the public policy considerations you as regulators take into consideration when encouraging U.S. banks to participate in these heavily indebted country new money packages and re-schedulings?

It is not prudent for a bank to lend new money to any borrower, whether for interest payments on existing debt or for any other purpose, unless there is a reasonable basis for believing that the lending of the new money will enhance the prospect that the borrower's total indebtedness can ultimately be repaid. In the case of heavily indebted countries, the lending of new money by banks has typically been linked to re-schedulings and new-money agreements and to the adoption of, and performance under, an IMF structural-adjustment program. The need to link adjustment programs and new money agreements is recognized in Secretary of the Treasury James Baker's "Program for Sustained Growth." That program requires that debtor countries adopt comprehensive macroeconomic and structural policies that will promote growth and balance-of-payments adjustment and that will reduce inflation in exchange for net new lending.

It is not the role of the OCC, however, either to encourage or discourage banks from advancing new funds in a particular circumstance. Consistent with safe and sound banking practices, the OCC will continue to assist national banks in facilitating transactions that will result in troubled LDCs being able to service their remaining obligations according to the terms of their debt agreements. Ultimately, however, banks should reach their own decisions about whether to participate in new money packages and re-schedulings.

We support the Administration's broader effort under the Baker Plan for new lending, accompanied by meaningful economic reform programs undertaken by the debtor countries and adequate support in the form of capital and reserves.

4. There are recent newspaper reports that banks are very hesitant, if not unwilling, to continue to participate in new money lending packages for heavily indebted countries. Many of those who are hesitant are regional banks. What will be the effect if these banks elect not to participate and the money center banks have to extend the majority if not all of the new money? (Effects being the impact on the health of these banks, [and] the ramifications for financing U.S. trade with these countries.)

Can money center banks afford to put together all the new money necessary?

The 21 largest U.S. banking companies currently account for approximately $81.3 billion, or 87 percent, ($80.6 billion, or 84 percent, as of year-end 1982) of U.S. bank exposure to the "Baker 15" troubled debtor countries[2]. If U.S. money-center banks were required to make up the entire shortfall caused by the complete withdrawal of U.S. regional banks from new money packages, their contribution to the packages would be increased by approximately 13 percent. Although we do not believe that regional banks will withdraw entirely from new-money packages, additional funding requirements in such an event could be managed by the money-center banks.

The impact of the increased lending on the health of the money center banks would depend upon the actual dollar amount of funds to be made-up. Each country's new-money requirements have usually been the subject of considerable debate and negotiation between the respective country and its bank lenders, and I cannot, with any degree of certainty, project the likely total of new-money packages for the entire group of heavily-indebted countries. However, for perspective, each $1 billion of additional loans would increase the exposure of the money-center banks (as a percentage of their aggregate primary capital) by slightly more than 1 percent.

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[2] Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, exico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and ugoslavia.

It is important to note that while regional banks may have reservations about participating in some new-money lending packages for LDCs, they are unlikely to view trade credits with those countries in the same way. The trade credits provided by U.S. regional banks have generally taken the form of confirmed letters of credit and bankers' acceptances, and have been in support of export sales by the banks' local (U.S.) customers. We would expect that this type of trade financing would continue, even if regional banks do not participate in new-money lending.

5. In your view, if we have an economic downturn, what is your opinion of the most heavily indebted countries' ability to service their debts?

What would the consequences be for U.S. money center banks?

The ability of most heavily indebted countries to service their debts is influenced by their ability to generate export earnings and foreign exchange. An economic downturn in the industrialized countries would likely have an adverse effect on LDCs' foreign exchange position; therefore, it is also likely that the ability of LDCs to service their debts would be affected by such a downturn.

U.S. banks are much less vulnerable to a downturn in the economies of their borrowers than they were at the beginning of the debt crisis six years ago. Since year-end 1982, the 21 largest banking companies in the U.S. have increased their primary capital by over $52 billion (to almost $95 billion), reducing the ratio of loans to "Baker 15" troubled LDC debtors to primary capital from 191% to 75%.

6. Press reports and the data you provided to this Committee both suggest that there are two banking industries -- one in good condition east of the Mississippi and the other in bad shape to the west.

   Students of banking history write that there are two traditions in banking. The Eastern tradition is for strict oversight and conservative bank operations. The Westerners are for go-go banking and as little oversight as possible.

   To what do you attribute the regional differences in bank performance? Have inadequacies in regulatory oversight compounded problems in the West?

Overall, the difference between the condition of banks in the East and that of banks in the West primarily reflects the condition of the local economies. Before the dramatic decline in energy prices beginning in 1981, the economies of the Eastern states were relatively weaker than those of the Western states, and this condition was reflected in the health of the banks of those regions. In 1980, the median return on assets of banks in the Eastern states was 1.07 percent and the median return on assets of banks in the Western states was 1.31 percent.

Regional differences in bank performance are not attributable to differences in how we supervise banks. The OCC does not have regional supervisory policies; we have one nationwide supervisory policy. The dependence of bank performance on local economies, however, does highlight the need to provide banks with opportunities to diversify their sources of income. If banks are allowed to participate in broader lines of business, they will become less vulnerable to downturns in their local economies.

While regional differences in bank performance in large measure reflect differences in local economic conditions, bank failures are a different story. Poor economic conditions obviously make it more difficult for a bank to make money, but management--not the local economy--is the primary determinant of bank failure. As we reported in our study of failed banks, survival when exposed to a weak economy depends fundamentally on the steps taken by management in good times and bad.

7. The testimony we have heard says that banks' noninterest income is rising strongly. However, we note that bank outlays on noninterest expenses have risen sharply this decade, particularly among the very big banks.

Does this suggest that our banks are becoming less efficient?

No, the rise in noninterest expense is not an indication that banks are becoming less efficient. It reflects the combined effects of a change in the way banks are doing business and the ongoing process of bank merger activity.

Only a few years ago, the earnings of most banks were largely composed of interest on loans and on securities held for investment purposes. In recent years, however, bank lending and investment activities have grown less rapidly than activities that generate fee income, such as loan originations and sales, discount brokerage, letters of credit, foreign exchange, and interest rate swaps. The operating costs for the new types of activities are primarily noninterest expenditures.

Market-driven expansion into new banking services has required extensive transitional noninterest outlays for management effort and new areas of expertise. These transitional costs have been made higher by the outmoded laws that constrain permissible banking activities. As banks gain experience in the offering of new products and services and the authority of banks to expand their activities is clarified, those expenses are likely to decline.

The observed increase in noninterest expenses also reflects the effect of increased bank merger activity. Moreover, some bank merger partners, particularly in interstate deals, are likely to experience operating inefficiencies in the short-term. Before a bank has the opportunity to realize increased efficiencies, it must first decrease any duplication in administration created by the merger or acquisition. It may take newly consolidated banks several years to overcome this overhead burden.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM
ROBERT L. CLARKE

1. The FDIC has submitted draft legislation to help deal more effectively with failed or failing banks that are part of multibank holding companies. My understanding is that this type of proposal would have saved the insurance fund a significant amount of money in some of the recent assisted transactions in Texas. What is your agency's position on this proposed legislation?

Recent experience with failing banks that are part of multibank holding companies has shown that there are legitimate concerns that bank holding companies, creditors of banks, and holders of holding company debt may be able to shift bank-failure costs from themselves to the FDIC. The FDIC's proposed legislation seeks to prevent such cost shifting, improve the asset quality of failing banks, and, in general, save the FDIC money in dealing with failed banks that are part of multibank holding companies. We support the objectives of the proposed legislation, and we anticipate that the extraordinary regulatory authority it would provide would be used infrequently.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CHAFEE FROM ROBERT L. CLARKE

1. How many new banks have you chartered over the last 5+ years, and do you take any additional steps to see that they do not fail?

Between January 1, 1983, and June 9, 1988, the OCC chartered 895 new banks. We have examination data on 870 of those banks (the rest are too new to have been examined); 38 have failed; 222 are currently considered problem banks (rated 3, 4, or 5 as of their last examination); and 69 have been merged or otherwise converted out of the national banking system. The remaining 541 newly chartered banks (60 percent of the total) are currently considered successful, and either have been rated a 1 or a 2 at the last examination (518 banks), or, though not actually examined, are owned by a sound holding company that has been recently examined.

In chartering new national banks, the OCC seeks to determine whether a proposed bank is likely to be operated in a safe and sound manner, possesses reasonable prospects for success, and can be expected to help meet the credit needs of its entire community. All applicants for national bank charters are required to present a sound business plan for the proposed bank.

The evaluation of factors that are essential to the success of the proposed bank includes an appraisal of the operating plan, the adequacy of capital, and the proposed management. The OCC monitors the applicant's efforts to get the bank organized, requiring that the organizers prepare and adopt appropriate statements of policy for the various aspects of the bank's operation.

An experienced OCC field examiner conducts a pre-opening examination of each newly chartered national bank. This examination covers all facets of the prospective bank's operation, and is intended to assure that the bank has established the policies, procedures, and operating controls that are necessary for the bank to serve its customers.

The OCC typically conducts a full examination of a new national bank six to twelve months after the bank opens. With our review of the operating plan, this examination provides the basis for the development of a supervisory strategy for that bank by the OCC. The OCC's supervisory strategy for all banks, including those recently chartered, is designed to respond to the unique supervisory needs of the particular institution. In practice, newly chartered banks, with limited histories and a high rate of deposit and loan growth, are more closely supervised than other banks of comparable size.

Historically, a new bank is vulnerable for the first 2 to 3 years of its life. That is why we require higher capital levels. Our management study reflects, however, that even new banks operating in some of the more distressed markets have been able to survive despite economic adversity.

The OCC does not, however, pursue a chartering policy designed to guarantee that new banks do not fail. The decision to apply for a charter is a private business decision of the organizers, and the OCC's approval of an application is not intended to be a guarantee of the profitable operation of the new national bank. Whether the operation of a new national bank will be profitable depends upon the ability of the bank's managers and upon the market it serves, including the condition of that market.

2. Are commercial banks essentially private-sector entities which perform certain public sector services, or are they quasi-public financial utilities on which societal demands can be loaded?

Banks are not public utilities, and they should not be treated as such. They do not meet the standard tests that ordinarily define a public utility. Treatment of a firm as a public utility is appropriate only when the nature of producing an essential good or service results in an individual firm gaining an excessive amount of market power. In order to guarantee the continued provision of the public utility's service, rigid and costly regulatory constraints are imposed to preclude competition as well as the failure of the institution. The regulatory constraints include legal barriers to entry and limits on final prices and rates of return.

Banking firms in the U.S. play a critical role in our economy as integral parts of the payments system. However, because of our highly diversified financial system, banks do not have the potential for the amount of market power usually associated with public utilities. Indeed, the competition that exists between banks and other financial service firms promotes product quality and availability.

Regulation and supervision is present in banking but is intended to protect against the threat of deposit runs and financial panics and to ensure adherence with consumer protection laws. That has been accomplished with federal insurance of deposits and regulations and supervision, ranging from portfolio restrictions to examination of individual banks. Within that context, commercial banks are left to compete with other firms in the provision of financial services and with all other firms for capital. If individual banks are successful, they continue to earn an adequate return for shareholders. Shareholders will withdraw their capital and invest it elsewhere if banks can't provide a competitive return. The market discipline that is exercised in the capital markets is one of the ingredients that ensures that these institutions are run efficiently.

As supervisors, we encourage national banks to recognize that improving the quality of their relationship with the communities they serve makes good business sense. For example, we have issued Banking Circular 206, "Basic Banking Services," which encourages national banks to provide basic banking services to their customers, including low- and moderate-income, young, and retired persons who may be unable to pay regular charges for conventional banking accounts. The OCC has also sponsored seminars on affordable housing, lending to small businesses, and banker responses to changing consumer needs. The purposes of these seminars were to heighten bankers' awareness of investment opportunities in affordable housing programs, small business ventures, and other consumer activities (A detailed listing of other steps we have taken may be found in our February 1988 report to Chairman Proxmire on the Community Reinvestment Act.) Nevertheless, as supervisors, we must also be cautious not to impose exceedingly costly regulatory burdens on the banks.

3. Why is the American public so unconvinced that their deposits are fully protected, when public official after public official states that there is not need to worry? Is it in any way due to a fear that supervision is inadequate?

We believe that the American public has confidence in the American commercial banking system and in their insured bank deposits. That regulatory agencies have been able to deal with the recent large number of bank failures is evidence of that confidence.

The FDIC provides full insurance for the first $100,000 per depositor, per bank. Most depositors have balances of less than the insured maximum, and thus are fully protected. The most persuasive evidence that the public has confidence in the safety of their deposits is that despite frequent accounts of bank failures and of bank operating losses that portend failure, "runs" by depositors holding fully insured accounts at FDIC insured banks occur infrequently.

Uninsured depositors, on the other hand, provide an important measure of market discipline. Moreover, they can adjust to the risk they face in a number of ways. For example, they can split their deposits among several insured institutions to obtain full coverage, and they can take their business to strongly capitalized and well-managed banks. The latter is an important market process that rewards healthier banks and provides an incentive for all banks to be responsive to the marketplace. It would be a mistake, therefore, to infer that because depositors move uninsured balances from weak institutions to stronger ones, they lack confidence in the nation's commercial banking system.

4. What are the major causes of the 10% or more turnover rate in bank examiners?

As I testified before the Committee, the OCC currently has a vacancy rate of 25 percent in its commissioned examination staff. This fact alone is of great concern, but what is even more troubling is that many of those who have left and not been replaced were our best and most experienced people. In exit interviews conducted with employees who left the OCC in 1987, over two-thirds of departing OCC employees cited compensation-related issues as the main factor influencing their decisions to leave. Examiners who left the OCC in 1987 received, on average, a 27 percent increase in salary. Executives who left OCC for positions in the private sector or with the other bank or financial institution regulatory agencies received salaries that averaged more than twice their OCC salaries.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ FROM ROBERT L. CLARKE

1. In a recently released GAO report I requested, it was suggested that the regulators were too lax in responding to the LDC debt crisis in a number of areas: requiring reserves against debt and predicting problem countries.

   This same report discusses how the federal regulators required only $2.3 billion in reserves. This past year the [b]ank[s] set aside voluntarily $21 billion. However, GAO estimates--based on secondary market estimations--that the banks will require $49 billion.

   Would you comment on GAO's assessment that you, as regulators, have been too lax in responding to the LDC debt problem?

   Would you discuss GAO's estimate of required reserves as opposed to what the [b]anks have set aside, and what you required?

The GAO report focuses on the difference between reserves held in accordance with the mandated Allocated Transfer Risk Reserve (ATRR) and the reserves GAO thought appropriate based on its analysis of the secondary market values of the LDC debt. Since the GAO estimated reserves were larger, it concluded that the committee created by Congress through the International Lending Supervision Act of 1983 (ILSA) to determine the ATRR has not required the banks to establish adequate reserves. Its conclusion that reserves are inadequate, however, overlooks the fact that in addition to the protection provided by the mandated ATRR, protection is also available from other sources such as general reserves for possible loan losses.

ILSA requires U.S. banks to establish an ATRR, a specific reserve, against assets whose value has been significantly impaired by protracted transfer risk problems. That is not the only protection banks have. Consistent with ILSA, we have also supported an expansion of banks' general loan loss reserves. Banks have built up their general reserves against the latent transfer risk in less severely rated loans--Other Transfer Risk Problems (OTRP) and Substandard categorized loans--that do not fit the definition of significantly impaired loans. OTRP loans are those that have had an interruption of payment, but the borrowers are taking positive actions to restore debt service, including adoption of an IMF or similar economic adjustment program. Substandard loans have also experienced an interruption of payment, but do not have protracted arrearages nor is the value of these loans impaired for lack of a definite prospect for orderly restoration of debt service in the near future.

Although we do not require general or specific reserves for OTRP and Substandard loans, we expect national banks to take into consideration OTRP and Substandard exposures in their capital and reserve planning, since downgradings to these classifications reflect current and anticipated weaknesses in the countries' abilities to service debt obligations. We consider the volume of these loans in determining the adequacy of banks' capital and reserves.

We continue to expect that national banks will ensure that their general loan loss reserves and capital are consistent with the condition of their international portfolios. The banks have responded to our policies by increasing their general reserves. In fact, the banks' vulnerability to country risk has been reduced substantially. Foreign exposures in the fourth quarter of 1987 for all U.S. banks are down $61 billion since the end of 1982, while the banks' total capital funds have increased by $58 billion.

The GAO bases its estimates that banks should have $49 billion in reserves on October 1987 secondary market prices of the LDC debt. In our opinion, the use of secondary market prices as the sole indicator of reserve adequacy is inadvisable. The so-called secondary market for troubled country loans is not well developed, with annual trading volume for 1987-88 of less than 10% of the total amount of LDC obligations outstanding. There is little depth or breadth in this market, and it is not supported by primary market makers. Further, there is no homogeneity of obligors, terms, or contractual conditions and covenants of the instruments being traded.

In conclusion, we do not believe that the determination of reserve levels should be linked to either an imperfect secondary market price or a broad-based formula. Indeed, the Congress has recognized that any reserves or loan loss requirements should be carefully implemented in order to ensure orderly credit markets. However, as part of our supervisory response, we shall continue to review alternative approaches, including the need for additional required reserves.

2. Last fall, I introduced S. 1117 to encourage the regulators to take a more pro-active role in responding to the LDC debt crisis[.] Specifically, S. 1117 seeks to encourage the regulators to:

   a) be more aggressive in classifying countries that require reserves,

   b) reward countries that are performing better/responding to their debt problems.

   Would you comment on this approach, especially in view of the recent GAO study I referred to?

As stated in the answer to the previous question, we encourage an expansion of the general loan loss reserves and increases in banks' capital for countries experiencing debt service problems. When we assess the adequacy of banks' capital and reserves, we consider the volume of those loans categorized as OTRP and Substandard, but not subject to an ATRR. The banks have responded to our policies by substantially increasing their general reserves and capital.

The number of countries that have severe delinquencies and a severe inability to restructure their debts, and are therefore subject to an ATRR, has increased from five to eight since 1983. A number of other countries have come close to being subject to an ATRR, but they have negotiated successfully with commercial banks or agreed to an IMF structural adjustment program in order to preclude an ATRR. Of course, whenever countries become delinquent 6 months or more and are unable to negotiate an IMF or similar adjustment program or fail to come to an agreement with their lenders, we will not hesitate to impose an ATRR. When these conditions exist, we will aggressively ensure that reserves are increased by an appropriate amount. Likewise, we shall continue to encourage banks to increase their general loan loss reserves.

With respect to your second objective, we already reward countries that try to improve their credit standings. Countries that work with their creditors, implement reforms, and demonstrate progress toward financial recovery and restored creditworthiness are rewarded by being upgraded in our risk categorization system. We shall continue this policy.

Finally, we recognize that resolution of the problems of LDC debtors will require more than ensuring that banks adequately reserve against their exposure to LDCs. Thus, we support innovative efforts to respond to the problems of LDC debtors. Some creative debt-service reduction options include debt-equity swaps, the Mexican debt-bond swaps, and exit and new-money bonds. For example, in two recent interpretive rulings we allowed a national bank to engage in debt-for-equity swaps. The rulings clarify the authority of national banks in this area, and we expect that more national banks will take advantage of this option in countries that encourage foreign investment and economic revitalization.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

H. ROBERT HELLER
MEMBER OF THE BOARD

July 8, 1988

The Honorable Jake Garn
Ranking Minority Member
Committee on Banking, Housing
  and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator:

During the hearing held on May 25 you asked that views be submitted on legislation prepared by the FDIC which would permit the Board to order the merger or reorganization of banks in a holding company system in order to address a failing bank situation.

I am pleased to enclose a copy of the Board's comments on this proposal.

Sincerely,

Robert Heller

Enclosure

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

June 29, 1988

The Honorable William Proxmire
Chairman
Committee on Banking, Housing and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

This is in response to your letter of June 6, 1988, requesting the Board's comments with respect to a legislative recommendation by the Federal Deposit Insurance Corporation which would permit the Board to order the merger or reorganization of banks in a holding company system in order to address a failing bank situation.

The proposal derives from the difficulties that the FDIC has encountered in attempting to deal with multibank holding companies in states that do not permit or limit branch banking. In those states, in a situation in which such a holding company owns failing and healthy banks, the company has an interest in passing on to the FDIC full responsibility for dealing with the troubled institutions, but also retaining the solvent institutions without using their assets in any way to assist in resolving the problem situation. This is both inconsistent with the holding company's obligation to serve as a source of strength to its subsidiary banks, but also greatly complicates the FDIC's task in attempting to minimize its costs and restore banking service.

The proposal is thus intended to prevent a holding company from shifting financial responsibility for some of its subsidiary banks to the FDIC while the holding company or its creditors or shareholders benefit from the remaining healthy segments of the holding company. It would in effect treat a multi-bank holding company system as a single banking institution, establishing the principle that the financial strength of healthy segments of the system be used to bolster the capital or financial resources of a distressed banking affiliate.

To deal with these problems, the draft legislation would authorize the Board to order a bank holding company to cause any or all of its subsidiary banks to be reorganized as subsidiaries of a subsidiary bank that is in danger of closing regardless of the location of the banks or to require them to be merged with the bank in danger of closing where the banks are located in the same state. In order to issue such an order, two preconditions must be satisfied: the chartering authority must certify to the FDIC that a bank owned by the holding company is in danger of closing, and the FDIC must certify to the Board that the proposed action would lessen the risk to the Federal Deposit Insurance fund or that severe financial conditions exist which threaten the stability of the significant number of insured banks in the relevant community.

To attempt to assure the legal validity of these actions, the proposed authority would be buttressed by a number of far-reaching provisions. The merger or reorganization order would override any provision of state or federal law as well as any provision in a private contract or the articles of incorporation or bylaws of the bank holding company or any of its subsidiary banks that might otherwise prevent or limit the merger or reorganization transaction. The merger or reorganization order would also not be subject to judicial review.

The statute recognizes that in certain circumstances it would result in a taking of private property, but provides an appraisal process for holding company shares and debt acquired before the statute's enactment, for any debt incurred for goods or services procured by an affected bank or holding company in the ordinary course of business, and for shares held by minority shareholders of affected banks. The proposed statute would also override provisions of contracts entered into after the date of enactment that would prevent a holding company from pledging, selling, or transferring the assets or shares of its subsidiary banks in connection with the provision of FDIC assistance in troubled bank situations.

The FDIC proposal is a significant and complex legislative initiative which would have a broad effect on private contractual rights as they pertain to banking institutions and could have important consequences for the financing of banking institutions generally. The Board believes that it is necessary to proceed with great care in this area because of the complexity of the issues raised by the proposal, its significance for the rights of creditors and shareholders of banking organizations and the potential impact on the financing of the banking system. Accordingly, the Board would recommend that hearings on the proposal be scheduled at the earliest opportunity in order to elicit views of all interested persons to bring out the full and perhaps unanticipated ramifications of the proposal, the nature and type of authority that should be provided, the situations in which the authority should be exercised and the scope of review for actions under the proposed statute.

These hearings may suggest improvements in the proposal that, while achieving its goals, could minimize the potential impact on private rights and on the operations of banking organizations. For example, the proposal as structured would only be implemented where a bank is in danger of failing. Experience has shown that in many cases when this point has been reached, the holding company is unable to provide the degree of assistance needed and substantial federal assistance is required. The Board believes it may be appropriate to examine whether, consistent with the public interest, the procedures described in the bill could be implemented at a much earlier stage where there would be a likelihood that prompt and effective action could stave off a deteriorating financial condition at a subsidiary bank and prevent the federal safety net from being used. This type of procedure, which could be preceded by a requirement that the holding company be provided an opportunity to submit and implement a capital or other plan to address the distressed situation at a subsidiary bank or banks, could minimize the effect on creditors and shareholders of the far-reaching legal actions contemplated by the legislation.

In addition, the proposal as structured is limited to banking assets. The hearing could explore whether provision should be made to require the nonbanking assets of the holding company to be used to support an ailing bank affiliate, particularly as the range of nonbanking activities available to bank holding companies is expanded to include securities and other activities.

In sum, the Board believes that before any legislative action is taken on the FDIC recommendation it would be appropriate to hold hearings to examine the complexities of the proposal, including the appropriate standards and situations under which this authority would be exercised, the implications of such a statute upon the operation and financing of banking organizations, as well as the availability of any alternatives to achieve the goals sought by the proposal. We would be pleased to work with the Committee to provide any assistance you may desire in this matter.

Sincerely,

(signed) Alan Greenspan

Governor Heller subsequently submitted the following in response to written questions from Chairman Proxmire in connection with the hearing held before the Senate Banking Committee on May 25, 1988:

Question 1: Pathologists have identified a number of causes for bank problems in the Southwest. Some say it's the sour farm and oil economy. Others say it is fraud, noting the high incidence of abuse in some of the failed institutions. Others say it is excessive risk-taking, noting that there are plenty of healthy, profitable firms operating under the same poor economic conditions as the failed institutions. Generally speaking, in percentage terms, what role do: 1) the local economy; 2) fraud; and 3) excessive risk-taking play in the ills of banks in the Southwest?

Secondly, what is the key to success in the Southwest? What course should bankers navigate to avoid future problems?

Answer: Depressed economic conditions, particularly when preceded or accompanied by a sharp unexpected decline in prices of the major product of bank customers, are, in general, the main initiating cause of problem bank situations. That seems rather clear, because the great majority of bank failures throughout this decade have taken place in states suffering serious economic problems. But bank management and boards of directors are not passive agents within the economic environment. Incompetent management, over-aggressive policies, and fraud have been found as compounding factors in a great many bank failures in states with depressed economies. And such factors can, also, as experience has shown, cause banks to fail or get into trouble even when economic conditions in their community and region are strong.

The "key" to success for banks in the Southwest as well as other areas of the country is to maintain strong management and responsible directors and follow policies that accord with time-tested principles of prudent finance. The lesson taught by experience in the Southwest as well as other regions of the country is clear--banks that adhered to those principles were in a much better position to withstand adverse effects of depressed economic conditions.

Question 2: The banking industry faces some of the same woes as the thrift industry in the Southwest. To tackle that problem, FSLIC Chairman Danny Wall has proposed an ambitious plan to consolidate the number of thrifts through a number of mergers. What are your views of this plan? What are its advantages and disadvantages? Should a "Southwest Plan" be adopted for the banking industry?

Answer: There is no question that under the right circumstances a series of mergers as envisioned under the Southwest Plan can, by achieving cost savings and improving managerial efficiencies, prove of important help in resolving the problems of the thrift industry. However, the Southwest Plan alone will not be sufficient to provide a solution for all the problems of insolvent thrifts and is not considered as such by the FSLIC. That is to say, in many situations solutions can only be reached through the infusion of additional capital, by the FSLIC and by private investors.

The FDIC appears capable of providing stability to the problem situations faced by commercial banks in the Southwest. The FDIC insurance fund currently has about $18 billion and, to date, it has generally been successful, in cases of troubled banks, in finding private investors willing--often after the FDIC has provided a capital infusion--to invest new capital into these institutions. And when the FDIC has been unsuccessful in finding a private party to acquire failing banks, it has been able to arrange for an orderly closing. There may be situations, of course, in which mergers and consolidation of troubled banks will achieve the kinds of cost reductions and managerial efficiencies that the FSLIC is attempting to achieve with its Southwest Plan, and we understand the FDIC is always interested in identifying such situations. But there does not appear to be a need for the FDIC to adopt a formal Southwest Plan for the banking industry.

Question 3: Is it prudential banking practice to encourage banks to re-lend and re-lend to cover interest payments?

What are the public policy considerations you as regulators take into consideration when encouraging U.S. banks to participate in these heavily-indebted country new money packages and re-schedulings?

Answer: A fundamental assumption of the current approach to the debt problem is that the borrowing countries need to achieve a higher level of economic growth and can do so while maintaining their debt-servicing obligations. That economic growth would be achieved by a combination of appropriate economic policies in the indebted countries, a net inflow of funds from the World Bank and other official institutions, and a modest amount of net new lending by private commercial banks. New bank lending to date has been a tiny fraction of the scheduled interest payments on outstanding debt to banks.

National governments have a role to play individually and through international institutions in providing an assessment of the plans and policies of the borrowing countries with debt-servicing problems. However, the ultimate decision to participate in a particular new loan to these countries rests with bank management and not bank regulators or other public officials. Bank lenders need to assess the economic status of the borrower including the extent to which the borrower's condition would be improved by net new financing as well as the implications of their non-participation.

As a bank regulator, the Federal Reserve must also act to ensure that bank lending decisions are consistent with safe and sound banking practices. In particular, the Federal Reserve, with the other bank regulatory agencies, has sought to encourage banks to be adequately capitalized and to have a prudent level of reserves.

Question 4: There are recent newspaper reports that banks are very hesitant, if not unwilling, to continue to participate in new money lending packages for heavily-indebted countries. Many of those who are hesitant are regional banks. What will be the effect if these banks elect not to participate and the money center banks have to extend the majority if not all of the new money? (Effects being the impact on the health of these banks, the ramifications for financing U.S. trade with these countries.)

Can the money centers afford to put together all the new money necessary?

Answer: The recent actions of some regional banks would indicate that their willingness to participate in continued new money lending packages for heavily indebted countries is questionable at best. Most of these banks were not major participants in the lending process to begin with. The largest 24 banks are the major U.S. lenders and most have so far agreed to continued lending to those countries making progress in economic adjustment.

Reluctance by some banks toward continued lending may have some negative effects on loan restructurings that include a new money package as part of the program. Some banks have agreed to participate only if all existing bank lenders also agree to participate. As more lenders attempt to decline to participate in new money packages, the more difficult it is to arrange a satisfactory agreement. Recent restructurings, however, have included some form of exit vehicle for those banks whose loan share is small and wish to discontinue participation in future lending packages. The market seems to be finding solutions to this problem.

If circumstances required money center and large regional banks to increase moderately their share of lending, the effect may not create a burden. So long as increases in capital resources continue to outpace the rate of new lending, then progress will still be made toward reducing the burden of loans to heavily indebted countries in banks' portfolios. In this regard, since 1982 loans to problem countries have fallen from 195 percent of primary capital to 97 percent for the twenty-four large bank organizations despite continued new lending.

Question 5: In your view, if we have an economic downturn, what is your opinion of the most heavily-indebted countries' ability to continue to service their debts? What would the consequences be for U.S. money center banks?

Answer: The Federal Reserve is not projecting a recession in the United States in 1988 or 1989. If a recession did occur, it could affect the heavily indebted less developed countries in a number of ways. On the negative, side, lack of growth in the industrialized countries tends to depress developing country exports and commodity prices. On the positive side, recessionary forces also lead to downward pressure on interest rates that could offset the balance of payments impact of a fall in export receipts. On balance, the net financial effect would differ across countries and it would be difficult to judge *a priori* whether the group as a whole would benefit or be hurt. Existing IMF facilities, as well as a new facility being developed to help countries with unforeseen external contingencies, would be available to aid countries in overcoming balance of payments problems that might arise as a result of an economic downturn. With regard to the indirect consequences on the viability of U.S. money center banks, these effects are likely to be small in impact for the reasons outlined. It should also be noted that banks have strengthened their capital positions in recent years, and are now in a better position to withstand shocks that are either domestic or foreign in origin.

Question 6: During the crash of October 1987, some banks complained that daylight overdraft caps prevented them from transferring money for their customers and that the resulting delays contributed to the problems of Terrible Tuesday.

In the Federal Reserve's judgment did daylight overdraft caps contribute to the financial sector problems during the crash?

Answer: During the period of the stock market break of October 1987, neither biweekly nor daily daylight overdraft caps had a restrictive effect on payments activities. It is the Federal Reserve's policy to waive overdraft restrictions when the Reserve Banks encounter serious outages or market conditions require that the limits be waived. Thus, the Federal Reserve limits were not binding on October 19 and 20. For example, the large banks in New York and Chicago used between 13.8 and 66.2 percent of their caps during the week of October 19-26. From these utilization rates, it is apparent that the money center banks had surplus overdraft capacity and so were not likely to delay funds transfers because of the Federal Reserve's overdraft limits.

These data lead us to conclude that the daylight overdraft caps did not have an adverse or destabilizing effect on payments activities during the stock market break in October 1987. According to the report of the Presidential Task Force on Market Mechanisms, certain banks declined to send transfers on behalf of their customers until they received covering funds from another source. This type of credit judgment exercised by the money center banks, however, was not related to the Federal Reserve's daylight overdraft limits.

Question 7: In your discussion of the LDC debt situation you speak of helping the debtor countries to "bring about external adjustment within a context of economic growth."

Has not the growth in per capita incomes been flat or negative in many of the Latin American debtor countries? Isn't external adjustment with growth just wishful thinking given the size of the adjustment necessary to service these debts?

Answer: Although some Latin American debtor countries have experienced negative per capita growth rates in recent years, on average these countries had a slightly positive per capita growth rate over the period 1984-87, a substantial improvement over growth rates experienced earlier in the 1980s. Moreover, most of these countries have made necessary external adjustments and can turn their attention to structural reforms that will have positive consequences for long-run growth. The response of real growth rates to such policy reforms is likely to differ across countries, and some countries may not implement needed reforms rapidly enough to increase growth rates dramatically or immediately. Still, the experience to date in individual countries that have moved strongly to implement structural adjustment measures, such as Chile, Colombia, and Uruguay, suggests that substantial growth in per capita income coupled with sustained external adjustment can be achieved.

Question 8: In your testimony you suggest that your Board views the Baker Plan as the best solution to the problems of the LDC debt crisis at the present time.

The Baker Plan called for increases in bank lending to accompany the increase in public lending. Have banks been following the Baker Plan by doing their share in the provision of new capital to these developing countries?

If the LDC loans were domestic loans do you not believe that the debtors would have gone to bankruptcy court and declared Chapter 11 by now? They would have gotten relief long ago.

Do not secondary market prices for LDC loans indicate that these loans are unlikely to be paid in full?

Answer: Net new bank financing for the countries associated with the Baker Plan has been less than the levels contemplated when the plan was formulated. The reasons for this lie in the behavior of the borrowing countries as well as that of the banks. It has become more difficult to sustain the new money process. Banks no longer clearly share the same commonality of interest in participating in new money packages.

The objective of a bankruptcy proceeding is not to provide debt relief per se. Rather, it is to provide a means through which the collective interests of creditors are taken into account. From this perspective, it is not clear that the borrowing countries would be better off financially or economically, or would have received more debt relief, if they had a Chapter 11 proceeding available to them.

Secondary market prices for bank claims on developing countries reflect a wide range of variables, some of which are not related to the probability that a loan would be repaid. For example, they may reflect banks' individual situations, including their willingness in the short run to incur losses on claims in order to exit from involvement in lending to particular debtor countries, or they may reflect the derived demand for claims resulting from debt conversion opportunities.

Governor Heller subsequently submitted the following in response to written questions from Senator Heinz in connection with the hearing held before the Senate Banking Committee on May 25, 1988:

Question 1: In a recently released GAO report I requested, it was suggested that the regulators were too lax in responding to the LDC debt crisis in a number of areas:

- requiring reserves against debt
- predicting problem countries

This same report discusses how the federal regulators required only $2.3 billion in reserves. This past year, the Bank set aside voluntarily $21 billion. However, GAO estimates--based on secondary market estimations--that the banks will require $49 billion.

Would you comment on GAO's assessment that you, as regulators, have been too lax in responding to the LDC debt problem?

Would you discuss GAO's estimate of the required reserves, as opposed to what the Banks have set aside, and what you required?

Answer: The International Lending Supervision Act (ILSA) of 1983 requires bank regulators to mandate special reserves--Allocated Transfer Risk Reserves--for those countries experiencing serious debt servicing difficulty. These reserves are the functional equivalent of a charge-off. Bank regulatory authorities have so far required approximately $2.3 billion of these reserves. The loans to which these reserves apply are to borrowers in countries where U.S. bank lending is small which would account for the perceived low level of reserving.

At issue, however, is the appropriate reserve level on loans to borrowers in those countries where debt burden is admittedly high but the country is taking steps toward resolving their financial and economic difficulties. Bank regulatory authorities since early in the decade have implemented policies designed to encourage banks to increase their overall capital resources of which reserves are one component in order to place themselves in a better position to deal with potential credit quality problems, including those associated with LDC debt. Some progress has been made in this area. Loans to heavily indebted countries with problems have fallen from 195 percent of primary capital to 97 percent in the twenty-four large banking organizations, with significant amounts of international loans.

Last year banks made significant provisions to the allowance for loan losses account. The increased provisions against loans to heavily indebted countries did not increase the overall capital resources of the bank to deal with any problem loans. This provisioning did, however, give banks more flexibility to adjust their loan portfolios through debt-for-equity swaps and other mechanisms such as the recent loan for bond swap in Mexico. Banks can now engage more freely in loan sales or swaps which may involve writing down the book value of the swapped or sold loan without it having an immediate effect on reported quarterly earnings.

The GAO used "secondary market" prices to compute the amount of reserves banks may need to account for future loan losses on loans to heavily indebted countries. This presumes that all banks involved in lending to heavily indebted countries will liquidate their existing portfolios. This is presently not the case. Most banks will continue to adjust their loan portfolios while only some banks will indeed exit international lending altogether. It may be appropriate for those banks intending to liquidate fully their loans to heavily indebted countries to base their reserve decisions on secondary market values. Banks who see their natural market as more global in nature and will likely continue to be involved in international lending will hold their assets to maturity. Setting aside reserves based on "secondary market" values for these banks would not be necessary. While no one can predict with any certainty the level of reserves that may be necessary, banks have generally followed conservative estimates based on managements' expectations of how their future plans will affect the value of their loan portfolios. Bank regulatory authorities continue to stress the need to increase overall capital resources as the primary backstop to any future losses that may be necessary on loans to heavily indebted countries.

Question 2: Last fall, I introduced S. 1117 to encourage the regulators to take a more pro-active role in responding to the LDC debt crisis. Specifically, S. 1117 seeks to encourage the regulators to:

a) be more aggressive in classifying countries that require reserves, and

b) reward countries that are performing better/responding to their debt problems.

Would you comment on this approach, especially in view of the recent GAO study I referred to?

Answer: The current regulatory structure for classifying transfer risk does try to produce the results you desire. The structure attempts to be aggressive in classifying countries that are not making progress in adjusting their economies while at the same time recognizing other countries that are adopting policies to enable them to work through the adjustment process, usually with the assistance of formal or informal international programs. The problem is that measuring the progress of responding to debt problems must be done over a reasonably long time horizon. Little progress would be served by classifying and declassifying countries based on short-term indicators. Bank regulatory authorities prefer to use performance as a key indicator. If a country has protracted arrearages that exceed six months and is making no effort to resolve these delinquent payments through a formal or informal adjustment program, then a severe classification is warranted.

The record has usually been, however, that once transfer risk is classified most countries do not fully cure their delinquency and make little real progress in resolving the imbalances that created the problem in the first place.

Most of the heavily indebted countries where U.S. bank exposure is large have, to date, preferred to work toward resolving their difficulties. Within a case-by-case format, the market, in concert with the debtors, creditors and multilateral agencies, is making progress toward resolving some of the countries' difficulties. Bank regulatory authorities should not interfere in the process but must, at the same time, ensure that proper recognition is being given to the risks involved. Therefore, banks are strongly encouraged to continue to build capital resources against their exposure to the heavily indebted countries.

Question 3: Various trade groups have reported problems for their members in obtaining export financing. You indicated in a recent speech that American banks are in fact reducing their participation in export financing.

1. How serious a problem do you view this for U.S. exporters and for U.S. banks over the long term?
2. Given that export credit tends to be less affected by country risk considerations (short-term, rarely rescheduled), what do you believe are the major factors causing this reduction in export finance activity by banks?
3. What steps do you believe are necessary to assure adequate export financing for U.S. exporters by commercial banks?

Answer: The issue you raise is a very important one which deserves continuing attention. There is no indication to date that major credit-worthy corporations have experienced difficulty in obtaining desired financing for any specific purpose. There may be emerging problems, however, for medium-size companies with relatively small transactions. These medium-size companies usually obtain financing from local banks. Trade finance has in the past been document and labor intensive. Many banks have cut back on this area during recent periods of high dollar levels and low export volumes. In addition, the economic and financial uncertainty prevalent in some countries adds to bankers' nervousness. While trade financing is usually exempt from regulatory classification schemes on transfer risk, nevertheless, a country's financial difficulties can result in slow payment adding to a bank's cost.

In the past, competitive forces have been sufficient to ensure that credit-worthy borrowers receive the necessary financing. As exports rise and become a more important component of U.S. business, more U.S. banks are expected to reenter the field. Foreign banks have also established a number of U.S. offices in major export centers that concentrate primarily on import and export financing.

This area does warrant close monitoring to ensure that all eligible borrowers, large and small, receive the necessary export financing facilities.

Governor Heller subsequently submitted the following in response to written questions from Senator Chafee in connection with the hearing held before the Senate Banking Committee on May 25, 1988:

Question 1: How many new banks have you chartered over the last 5+ years, and do you take any additional steps to see that they do not fail?

Answer: While the Federal Reserve does not charter banks, it does approve applications from state-chartered banks for membership in the Federal Reserve System.[1] During the six years between 1982 and 1987, the Federal Reserve granted membership to a total of 255 new state-chartered banks.

The Federal Reserve Board recently promulgated several measures to preserve the safety and soundness of new banks. Normally, the System examines small banks in good condition every year. *De novo* banks, however, now must be examined at the end of their first quarter of operations and every six months thereafter until they receive two consecutive CAMEL composite ratings of 1 or 2, and, in the judgment of their Reserve Bank, can be expected to continue operating on a sound basis. Reserve Banks also are charged with establishing programs for tracking the performance of new banks as part of their overall bank monitoring efforts.

The Board also has taken steps to tighten application standards for *de novo* banks. A new bank must demonstrate that it has sufficient initial capital to support a ratio of primary capital to total assets projected at the end of three years of at least 10 percent, without further capital injections. While the Board long has considered this startup capital standard on an informal basis, it now formally requires that a de novo meet this standard before its application for membership can be approved.

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[1] National banks, once they are chartered by the Office of the Comptroller of the Currency, automatically become members of the Federal Reserve System.

In addition, the Board has placed restrictions on de novo banks that are established as subsidiary banks of prospective bank holding companies. The Board has had a long-standing policy that the debt-to-equity ratio for a small bank holding company formation not exceed 1:1, that is, its debt should not exceed its equity capital, if the proposed subsidiary bank is being formed de novo. This policy has been supplemented by a requirement that prohibits a subsidiary de novo from upstreaming cash flows to the parent bank holding company until the bank has received two consecutive CAMEL composite ratings of 1 or 2, and, in the judgment of the Reserve Bank, can be expected to continue operating on a sound basis.

Question 2: Are commercial banks essentially private sector entities which perform certain public sector services or are they quasi-public financial utilities on which societal demands can be loaded?

Answer: In response to your question concerning the appropriate characterization of the functions served by commercial banks, they are clearly private sector profit-making institutions, not public utilities. These depository institutions do, however, perform a number of specialized functions that are vital to the effective functioning of the nation's monetary system. The ability of banks to perform these functions requires a high degree of public confidence in their ability to meet their deposit obligations. Deposit insurance and direct access to a lender of last resort constitute an important public safety net under the deposits received by banks and are designed to help maintain public confidence in the banking system. They reflect a long-standing consensus that a strong and stable system is important to the maintenance of a healthy economy. The presence of this safety net, and the public financial commitment implied by these facilities, also requires a regulatory framework designed to establish safe and sound operation. However, to assure a viable and competitive banking system capable of effectively meeting consumer needs, this regulatory system should be only as intrusive as absolutely necessary to maintain safety and soundness.

Question 3: Why is the American public so unconvinced that their deposits are fully protected, when public official after public official states that there is no need for worry? Is it in any way due to a fear that supervision is inadequate?

Answer: Despite the media attention given to the recent spate of failures of banks, and particularly of thrifts, experience indicates that the public generally remains confident about the safety of funds they have deposited in insured accounts at commercial banks and savings and loan associations. Depository financial institutions have continued to enjoy considerable deposit growth. At thrifts where adverse news about problems in the industry and a shortage of resources at the insurance fund have been extensively reported, deposit growth has averaged about 6-1/2 percent over the past year, in line with growth in 1985 and 1986. Indeed, growth at S&Ls over the period has exceeded that at commercial banks even though the deposit insurance fund for commercial banks is generally considered to have resources adequate to deal with the problems in the industry.

In some part, the relatively rapid growth at thrifts is traceable to certain institutions experiencing problems offering above-market rates to attract funds. But the very fact that depositors are willing to place funds with an institution under such circumstances--and existing depositors to keep their funds on deposit with the institution--indicates a fundamental confidence that funds so deposited are secure. This confidence presumably exists because the public believes that ultimately the resources of the federal government lie behind the insurance fund. The Congress, of course, in CEBA, stated "it is the sense of the Congress that deposits up to the statutory prescribed amount in federally insured depository institutions are backed by the full faith and credit of the United States," and many members of the public are aware of that statement.

Question 4: What are the major causes of the 10% or more turnover rate in bank examiners (Question 13, page 159 of FDIC May 16, 1988 Information submission)?

Answer: Federal Reserve examiner turnover ranged from 11 to 18 percent during the years 1975 through 1987 averaging approximately 15 percent for the period. That rate of turnover is much higher than desired. Training of new personnel is quite expensive and, equally important, it takes approximately five years before an inexperienced new hire becomes a well-trained and experienced examiner.

We conducted a survey of departing examiners last year to find out reasons why they were leaving. They gave a variety of reasons but those most frequently offered were a promotion/promotional opportunity and to take a new job outside the Federal Reserve offering a higher salary. The 12 Federal Reserve Banks which are in major job market areas compete with local financial institutions (and others) for the services of trained examiners who are qualified to fill positions such as loan officer, financial analyst, auditor, loan reviewer, and a variety of other financially related jobs. Financial institutions recognize that a trained examiner offers them a combination of skills and experience not readily available within the ranks of recent graduates of institutions of higher learning. Consequently, examiners are often targeted by recruiting firms as ideal candidates to fill key positions.

Excessive travel was not mentioned as a major reason for resignation. Many Reserve Banks now have travel incentive plans that provide some remuneration for those who travel in excess of certain limits.

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BANKING IN TROUBLED TIMES: WHAT HURTS? WHAT HELPS?

Remarks by
ROBERT L. CLARKE
Comptroller of the Currency

before the
ABA's Stonier Graduate School of Banking

Newark, Delaware
June 20, 1988

Thank you and good evening.

Several years ago, the American existentialist philosopher Woody Allen began a graduation speech in this way: "More than any other time in history, mankind faces a crossroads. One path leads to despair and utter hopelessness. The other, to total extinction. Let us pray we have the wisdom to choose correctly."

Allen wasn't talking to the Stonier School of Banking. But if he had been, he would merely have been echoing widely held sentiments about the banking industry.

Throughout the 1980s, the number of troubled banks, and the number of bank failures, have risen dramatically.

In the Midwest and the Southwest especially, depressed conditions in agriculture, in energy, and in real estate have pummeled banks like tempests battering ships at sea.

Hundreds of banks have foundered. Hundreds more have barely weathered the storm. Yet, others have righted themselves. And thousands in America's heartland have sailed through the storms practically unharmed as a matter of course.

Over the last year, the Office of the Comptroller of the Currency undertook a detailed study to gain a better understanding of why the performance of banks diverged so dramatically when they were faced with similar declines in their economic environments over the last decade.

We looked at three groups of banks: those that failed, similarly situated banks that experienced problems but were restored to health, and banks whose condition never deteriorated despite the problems in their local economies.

We were looking for the answers to several questions. What common characteristics and conditions were present in failed banks? Were there characteristics and conditions in common among the problem banks that rebounded, both when they were deteriorating and when they were rehabilitating themselves? What characteristics and conditions did the consistently healthy banks share? Did the characteristics and conditions differ significantly among these groups of banks? Why do many banks that operate in a depressed economy remain relatively healthy? What went wrong in the failed banks? And, most important, if we could find what went wrong in the failed banks, can anything be done about it? In other words, the big question we sought to answer was: do some banks, as a matter of uncontrollable fate, of economic determinism, face a crossroads where one path leads to despair and utter hopelessness and the other to total extinction?

The thesis I present to the Stonier School of Banking tonight is: in the vast majority of cases, banks are not the prisoners of fate -- damned if they do, damned if they don't.

Most often, banking performance, good and bad, is primarily the result of managerial behavior, even in depressed economic environments.

In most cases of bank performance we reviewed, specific patterns of practices within a bank itself determined its success or failure, although economic problems in the market served by the bank often played a contributing role.

Our findings shouldn't come as a complete surprise.

Last January, we released the preliminary results of the first phase of our study, a phase that focused on our analysis of the common characteristics and conditions in national banks that failed over the last decade.

Based on our preliminary findings, we concluded that, while poor economic conditions certainly make banking more difficult, the efforts of management have greater influence on success or failure.

We found that the most common characteristic of failed banks was that they were poorly managed, and by that I mean that the banks failed to establish and adhere to policies, they failed to develop managerial direction and routine, that would see them through bad economic times.

In the second and final phase of our study, which I'm here to discuss tonight, we performed the same analysis on similar groups of rehabilitated and healthy banks as we did on the failed banks. The results of the second phase were to be a test of the findings in the first phase. In other words, through comparison and contrast of the three groups of banks, we sought to determine whether successful banks established and adhered to policies that would see them through bad economic times.

We had a theory, based on years of experience in supervising banks in a variety of geographic and economic markets, that sound operating policies and procedures would enable banks, as a general rule, to weather economic difficulties in the markets they serve.

We found that our theory was valid.

Before I turn to our study's findings in detail, I want to briefly describe how we went about developing those findings.

In the first part of our study, we analyzed 171 _failed_ national banks to identify characteristics and conditions present when these banks deteriorated. These banks were 94 percent of the national banks that failed between 1979 and 1987. Nine out of ten of these banks had assets of $100 million or less, and almost eight out of ten had assets of $50 million or less. Eighty-five percent of these banks were in our Midwestern, Southwestern or Western supervisory districts.

We conducted the same evaluation for a sample of 51 _rehabilitated_ banks in similar circumstances that experienced significant difficulties and recovered. By that I mean that, according to our rankings, these banks fell from being among the healthiest banks to being problem banks, and then returned again to health, during the years 1979 through 1987. We looked at them both when they were declining and when they returned to health. Again, about nine out of ten of these banks had assets of $100 million or less. Eight out of ten were located in our three western districts, and they included banks in Dallas, in Houston, and in Oklahoma City.

Finally, we evaluated a sample of 38 healthy banks facing economic problems that maintained good or superior supervisory ratings, our two highest ratings, during the same period. Again, about nine out of ten of these banks had assets of $100 million or less and eight out of ten were located in our three western districts.

In other words, the rehabilitated bank and healthy bank samples were chosen to conform as closely as possible to the failed banks in terms of location, problems in the economy, and asset size.

Using examination reports, bank histories prepared by OCC examiners, and other information provided by banks and examiners, we subjectively, and I stress the word, "subjectively," evaluated each bank's performance in eight broad categories: policy, planning, and management quality; audits, controls, and systems; asset quality; liquidity and funds management; nonfunding expenses; insider abuse; fraud; and economic environment.

Within each of the eight categories, we evaluated a number of specific characteristics to determine whether each was significantly present, marginally present, or not present at all. By evaluating these factors, it was possible to detail the particular difficulties and strengths that banks had within each of the broader categories.

Why do I stress that our study is a subjective evaluation? First of all, the evidence we worked with was itself a compilation of subjective evaluations. Bank supervision, after all, is a judgment business. The tools in a bank examiner's kit -- financial formulas, statistical sampling and so on -- are intended to present the examiner with the means to measure a bank's financial condition objectively. But once the numbers are run, the examiner's own knowledge, experience and expertise come into play in interpreting what the numbers mean. Second, we approached the evidence to write a clinical history of what went wrong, and what went right, in a large number of specific case histories in the past. Historical accounts are invariably subjective.

Furthermore, rather than trying to establish cause-and-effect, the goal of science, we were trying to discover whether there exist associations among a number of factors we reviewed and, if there do, to get some idea of how strong these associations were. Rather than seeking immutable laws of nature, we were searching for broad correlations. As a result, we don't claim that our study is "scientific" in the technical meaning of the term.

But that doesn't mean that it isn't meaningful or accurate. Just as a painting may be just as accurate and more meaningful than a photograph, we believe this study is just as accurate, and at least as meaningful, as a technically scientific study would be.

Many years ago, when the hard-drinking Hack Wilson was slugging for the Brooklyn Dodgers, his manager, Max Carey, called a meeting of the entire team. Although Wilson was hitting .300 for the Dodgers and pumping out home runs, Carey believed he had to save Wilson from his drinking habit somehow. Although he had done no scientific study of the effects of mass alcohol consumption on ball-players, Carey's experience and judgment told him that drinking diminished athletic performance.

So Carey tried the psychological approach to wean Wilson from drink. Nothing had worked.

As he called the player meeting together, Carey stood at a table on which he had placed two glasses and a plate of live earthworms. One glass was filled with water. The other was filled with gin, Wilson's favorite drink.

With a flourish, the manager dropped a worm in the glass of water. It wriggled happily. Then Carey plunged the same worm into the gin. It stiffened and died.

A murmur ran through the room.

Some of the players were obviously impressed. Not Wilson. Hack didn't even seem interested. Carey waited a little for some delayed reaction. When none came, he prodded: "That mean anything to you, Wilson?"

"Sure, sir," the star player answered: "It proves that if you drink gin, you'll never have worms."

Scientific observation is, in and of itself, no guarantee of meaning or accuracy.

All that being said, what did our study find?

Tonight I will describe in detail our findings in four areas: general management; loan portfolio management; the role of the chief executive officer; and fraud and abuse.

I will then discuss why some problem banks recovered while others failed, and why the continuously healthy banks stayed healthy. Finally, I will put our findings in perspective.

As I said before, management -- by senior officers, by the board of directors -- is key to a bank's success or failure. Managers must manage or suffer from the consequences of their failure to do so.

Now management is one of those cosmic terms that covers a multitude of virtues and skills. It includes strategic vision, a vision of where the management wants the institution to be five years from now or ten years from now. It includes inspiring and motivating staff, that is to say how to get people to do what you want them to do when you want them to do it, how to take responsibility and to be accountable for it. It includes so much that it is virtually impossible to define "management" definitively. But for the purposes of our study, we didn't need a definitive definition, only a working definition. For the purposes of our study, we defined management as a process to ensure the right things are done and that things are done right.

To manage is to maintain control. To maintain control you have to make decisions. To make decisions you have to know what is going on in your institution and you have to have the means to take action when you need to. In other words, you have to know where you are, where you want to go, and how to get there. And you have to do these things day-by-day, or ensure that they are being done, or the institution will soon be out of control.

Our study found that deficiencies within boards of directors and management were the primary internal problems of problem and failed banks.

We found that more than half of the failed banks had directorates that either lacked necessary banking knowledge or were uninformed or passive in their supervision of the bank's affairs. And, significantly, more than half of the rehabilitated banks had similar deficiencies as they declined into problem status.

In contrast, none of the boards of the continuously healthy banks, or of the rehabilitated banks upon their return to health, had significant deficiencies in these areas.

As I stated before, as part of our evaluation of management, we looked at the policies, controls and systems of every bank in the study. Significantly, we found that these problems at failed banks were related to poor board or management supervision:

Most failed banks either had no loan policies, or, if they did, the policies were not followed. Most had inadequate systems to ensure compliance with internal policies or banking laws. Most had inadequate controls or supervision of key bank officers or departments. More than half had inadequate problem loan identification systems. In more than half, one dominant individual made decisions. And about half had nonexistent or poorly followed asset and liability management policies.

In general, we found that our group of rehabilitated banks had similar problems during their decline as the failed banks did. In other words, problem and failed banks consistently lacked policies, systems, and controls to guide their staffs in performing the necessary job of managing an income producing loan portfolio.

In contrast, while healthy banks were not immune to some of the negative factors found in problem or failed banks, these detrimental conditions were less frequent or intense, and healthy banks were less likely to have them in combination.

Almost all the healthy banks had strong controls over key bank officials. Most had strong management information systems. More than half had strong problem loan identification systems. Half had strong loan policies, policies that were followed. And almost half had fully effective systems to ensure compliance with internal policies and laws.

We also looked at the loan portfolio management practices at every bank in the study. Here we found another set of problems that prevailed in failed banks, a set of problems that generally reflected overly aggressive activity, which can be described as when the management or board was excessively growth minded, or when they followed liberal credit views.

Aggressive, growth-minded behavior is not, in and of itself, a weakness. In fact, when an aggressive approach is combined with well-established policies and controls, it can be a successful strategy. But we found that when an aggressive approach is not combined with such policies and controls, there are likely to be problems.

In most of the failed banks we found that the board or management was overly aggressive to some degree; and in almost half, the boards were aggressive in a way that had had a significantly negative effect on performance.

What set of problems did we find in loan portfolio management practices?

Most failed banks followed liberal lending practices; that is to say, liberal repayment terms, collection practices, or credit standards. None of the healthy banks did. More than half of the failed banks had excessive loan growth in relation to their resources to back it up: managerial ability, staff, control systems or funding sources. Virtually none of the healthy banks did. More than half of the failed banks had problems with an over-reliance on collateral-based lending. Virtually none of the healthy banks did.

Almost half of the failed banks placed undue reliance on volatile liabilities, and many had problems with inadequate liquid assets as a second source of liquidity.

During their decline, the rehabilitated banks also experienced problems associated with overly aggressive behavior, but significantly less frequently than the failed banks did.

I want to stress that, among the healthy banks, overly aggressive behavior was nearly nonexistent.

This evidence indicates that overly aggressive behavior may well underlie severe problems and make recovery from those problems much less likely.

Overly aggressive behavior -- for example, growth for growth's sake, or growth without the resources [illegible]k it up -- is a highly risky strategy because it leaves the bank [illegible] when the economy turns down.

In other words, when the economic tide goes out, you find who is swimming naked.

One finding from our study appears self-evident at first glance: the capability, experience and integrity of the chief executive officer is probably the most important determinant of the success or failure of a bank.

Our study gives us a clearer perspective of just how much that is the case: CEOs had significant weaknesses at many of the failed and problem banks.

We found that almost two-thirds of the failed banks had CEOs who clearly lacked the capability, experience or integrity necessary to make their banks successful. Most of the rest of the failed banks had CEOs who showed some signs of weakness in these areas. In the rehabilitated banks in their declining stage, more than half the CEOs had at least marginal shortcomings, and a large number evidenced significant shortcomings.

By contrast, in the continuously healthy banks, there were no problems apparent with CEO experience, capability, or integrity.

It is a commonplace to compare the CEO to the captain of a ship. This comparison is a cliche because the surface similarities are so striking. But in terms of banking, the similarities go far deeper than the surface. The captain determines where the ship will go and how it will get there. That's navigation. But it is also the captain's responsibility to ensure that the ship is in optimal condition, ship shape, so captains are steeped in engineering and ship handling to understand each of a particular vessel's strengths and weaknesses. That's practical nautical expertise. Furthermore, the captain must have the knowledge of how to function in varying circumstances -- calm seas and high, good weather and bad -- knowledge in theory and in practice, in general for all ships and in particular for the one in his charge. That's seamanship. Finally, the captain must know the responsibilities of his crew, must make sure that they know what their responsibilities are, and must hold them accountable for doing their jobs. That's command.

The captain's skill, expertise, knowledge and effort are the most important factors that determine whether the ship remains afloat or smashes up on the rocks; whether the ship ends up at the destination, or ends up adrift, the prisoner of currents.

A captain needs tools to do the job: compass or computer for charting and remaining on course. And a captain needs frequent and complete reports from his officers to ensure that his commands are being followed, that the ship remains on course, that nothing is going wrong.

Why must a captain know so much and do so much?

The captain cannot control the sea, so he must have complete control of his ship.

The bank CEO has no control over the economy, so he better have control over the bank.

Remember, too, that a CEO is like a ship's captain in one other important respect.

Traditionally, the captain goes down with his ship.

That reminds me of an incident that occurred at the end of World War II. Admiral Nimitz and General MacArthur were fishing together in a small boat off the coast of the Philippines. In a sudden squall the boat capsized, and the eminent warriors found themselves floundering helplessly in the water. The admiral was the first to pull himself up on the keel of the capsized boat, and with the aid of an oar he finally was able to pull the general up, too.

After catching their breathes, the admiral said to MacArthur: "Now, Mac, please don't mention this to anyone. You see, I'd be disgraced if the men of the Navy learned I can't swim."

"Don't worry," MacArthur replied, "your secret is safe. You see, I'd hate to have my men find out I cannot walk on water."

No one expects bank CEOs to be able to walk on water, but it's not unreasonable to expect them to show leadership and capability what ever way the weather blows.

I would like to touch on the last major area of findings in our study: insider abuse and fraud.

Insider abuse was a significant factor leading to failure in about a third of the failed banks. About a quarter of these failed banks with significant insider abuse also had significant problems involving fraud.

During their decline, about a quarter of the rehabilitated banks experienced significant insider abuse.

In contrast, of the continuously healthy banks, only one had a marginal problem with fraud and another with insider abuse.

As you might expect, problems of insider abuse and fraud were often related to the lack of oversight and controls. Several conditions, found more often in failed banks that experienced significant insider abuse and fraud than in failed banks that did not, may have provided the opportunity for such problems to become significant. They included: inadequate supervision of key officers; a dominant decision maker; unwarranted concentrations of credit to one industry; and inadequate guidelines for purchasing loan participations.

Generally these conditions, with the exception of a bank's reliance on one dominant decision maker, were at worst only marginally apparent at the continuously healthy banks.

Apparently, proper supervision of bank officers and formal guidelines to monitor and control lending practices also helped to limit insider abuse and fraud.

Why did some problem banks recover while others failed?

In looking at the problem banks that recovered, we found that a number of factors contributed to their rehabilitation, including: changes in management; improved banking practices; changes in banking philosophy; capitalization; and improved local economic conditions.

In spite of a few lingering problems found at the rehabilitated banks, their efforts to make important changes were clear.

Also, the fact that rehabilitated banks -- during their decline -- were less likely to have an overly aggressive board of directors or to follow practices that might be judged overly aggressive worked in their favor.

Furthermore, rehabilitated banks had a much better record of compliance or partial compliance with administrative actions taken by the OCC than the failed banks did. While we took administrative actions in roughly similar percentages with the failed and rehabilitated banks, the rehabilitated banks made a serious or competent effort to meet, and succeeded in meeting, our directives more than twice as often as the failed banks did.

While a banker's job is undoubtedly easier in a strong economy, strong management and systems can prevent failure and promote recovery even during difficult economic times if management and the board of directors act quickly and positively.

The evidence in our study shows that attention to and compliance with administrative actions have a positive effect on a bank's condition.

Why did the continuously healthy banks stay healthy?

Our analysis showed that the banks we evaluated were not totally free of managerial shortcomings or externally generated economic problems. However, we found that these banks generally had far fewer internal difficulties -- in management, in systems and controls, and so on -- than the banks in the other groups. Clearly, the best way for management to weather an economic storm is to minimize internal shortcomings.

A strongly managed bank with adequate systems in place and followed is best prepared to remain profitable in bad times as well as in good times. The way to maintain a bank's health, therefore, appears to be to limit the number of shortcomings of management, the board of directors, and the policies and systems they put into place.

Although the healthy banks were not completely without weaknesses, their weaknesses were generally isolated and offset by strengths in other areas.

I can draw an imperfect analogy between a person's health and a bank's health.

You are probably not doing yourself grievous harm if you have a cigar once a month or a glass of wine on Saturday night or a piece of cake on your birthday or you don't exercise quite as much as you should or you are five pounds above your optimal weight. But chances are that your patterns of behavior have left you in poor shape to weather a sudden onslaught of stress and strain if you smoke two packs of unfiltered cigarettes a day; and you drink a quart of gin every night; and the staples of your diet are doughnuts, pizza and beer; and the last time you broke into a sweat from physical exercise was in high school gym class.

Building a strong bank, one that can survive stress and strain, requires the same commitment and attention to detail. the same conscious effort to do the right things, as building a strong body does. Or, looking at it another way, good management practice, in banking or any other business, is a mosaic of management procedures that, when isolated, may not be that meaningful but that, when fitted together with understanding and imagination, create order.

It has been said that the difference between school and real life is that in real life first you get the test, then you learn your lesson. Over the last decade, many banks have been tested. Some have passed. Others have failed. But there are lessons in all of their real life experiences for bankers everywhere.

Bankers are not in a position to exercise any great influence on the external conditions they face. Like the captain of a ship, they sail on an ever-changing sea. But, again like a ship's captain, bankers are in a position to ensure that their charge is prepared for whatever change the future may bring. Bankers are in a position to change their internal operating procedures. If bankers don't plan and prepare now to endure change, they will likely pay later.

Our study demonstrates that banks are able to remain healthy institutions throughout economic fluctuations by establishing and maintaining strong internal policies, systems, and controls. Without such policies, systems and controls, banks are more likely to succumb to external pressures.

Problem and failed banks are almost never simply the result of depressed economic conditions. There is no single, simple reason why banks get into trouble or why they don't.

There is no single panacea that will swiftly and surely transform a troubled bank into a profitable and sound institution.

Management -- day-to-day management -- nuts-and-bolts management -- is an attitude and a series of basic, fundamental steps that, taken together, keep an institution healthy and that restore strength and profitability to those institutions that have declined.

In the evolving business of banking, the successful bankers will be those who understand the risks of the businesses in which they are engaged, who ensure the expertise of their board and management, and who establish the operating capability to handle the products and services they offer.

I would like to close by again quoting the words of the American existential philosopher Woody Allen: "Life is divided into the horrible and the miserable." For bankers, neither has to be the case. Bankers have a choice.

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Financial Institutions Consulting

Deposit Insurance and
Banking Structure Studies
Public Policy Analyses
Strategic Planning

August 8, 1988

The Honorable William Proxmire, Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, D. C. 20510-6075

Re: Response to questions posed by Senators Garn and Chafee to Bert Ely following his testimony to the Senate Banking Committee on May 19, 1988.

Dear Senator Proxmire:

I am pleased to respond to the questions Senators Garn and Chafee posed to me following my May 19, 1988, testimony to the Senate Banking Committee. Please accept my apology for taking so long to respond to these questions. My responses are as follows:

Garn question number 1. What methodology was used to determine your estimate of the size of the potential losses facing FSLIC. For example, how does your method take into account future oil prices, future real estate prices, and other economic variables? If so, what adjustments to these historical futures [figures?] have you incorporated to calculate future costs?

Response: Enclosed with this letter is a five-page description of the methodology I used to estimate FSLIC's accumulated insolvency loss as of December 31, 1987. Attached to this description are three exhibits. Exhibit 1 compares FSLIC's estimated resolution cost in twenty-three cases it resolved in early 1988 with Ely & Company's December 31, 1987, estimate of FSLIC's loss in these cases. For these cases taken as a whole, FSLIC's resolution cost was 15% higher than Ely & Company's estimate for this group. Exhibit 2 illustrates the total assets, at estimated market value, negative net worth, and total liabilities of the 853 thrifts Ely & Company considered to be hopelessly insolvent at December 31, 1987. Exhibit 3 presents a geographical breakdown of Ely & Company's loss estimates.

Ely & Company's loss estimation methodology is based on known economic conditions at the end of last year. As such, it incorporates an estimate of the marketplace's outlook for future oil prices, future real estate prices, and other economic variables as of the end of 1987. Beyond this, Ely & Company did not attempt to predict the future in its estimate of FSLIC's accumulated insolvency loss.

Separately, as discussed on page 3 of the written testimony I submitted on May 19, I estimated that FSLIC's accumulated insolvency loss was growing at the rate of at least 15% annually, before taking into account the monies FSLIC expends to dispose of insolvent thrifts. This compounding rate could vary dramatically with future interest rates, oil prices, real estate prices, and overall rates of asset deterioration or appreciation. In my opinion, predictions for the future should focus on this compounding rate, not on estimates of FSLIC's accumulated insolvency loss.

Garn question number 2. What assumptions do you make regarding the cost of funds at insolvent institutions? Since there has been a steady decline in the so-called "Texas premium," what effect does this have on your loss estimate? How have future interest rates been incorporated into your estimate of losses?

Response: As discussed in the attached description of Ely & Company's methodology, the assumption was made that the median cost of funds for healthy thrifts would decline by twenty basis points if the FSLIC mess was completely resolved. This decidedly optimistic assumption would save far more than twenty basis points in the cost of funds for many institutions and thus eliminates the Texas Premium.

Future interest rates were not incorporated in the $64 billion estimate of FSLIC's accumulated insolvency loss at the end of 1987. Rather they are reflected in the separate estimate of the rate at which FSLIC's accumulated insolvency loss is compounding. The 15% compounding rate mentioned in the testimony effectively assumes no material change in overall interest rate levels.

Garn question number 3. Since October, 1987, there has been a steady increase in net new deposits at thrift institutions. To the extent these new funds are invested at positive spreads, won't this reduce the potential losses at thrifts? Have these positive earnings been incorporated into your estimates?

Response: The change in deposit levels and the impact of that change in interest rate spreads is implicitly incorporated in Ely & Company's loss estimate.

The suggestion that the recent increase in thrift deposits has had a beneficial impact on FSLIC's accumulated insolvency loss is highly debatable. My written testimony, at pages five to seven, suggested that depository overintermediation is weakening all depository institutions. If this is so, then deposit growth ultimately is detrimental, not beneficial, to FSLIC.

A more specific indication of this point is the following piece of data: From September 30, 1987, to March 31, 1988, 42% of the thrift industry's total deposit growth occurred in deposit accounts with balances of at least $80,000. As we all know, deposits accounts of this magnitude, which is more than ten times the average size account in the thrift industry, are highly rate sensitive and thus relatively expensive money for the thrift industry. Thus, I must conclude that the industry's recent deposit growth has not been beneficial for it.

Garn question number 4. What mix of liquidations versus mergers have been assumed in your estimates? How will a change in this mix towards more mergers influence your results?

Ely & Company's estimate of FSLIC's accumulated insolvency loss did not explicitly address the mix issue. However, the attached description of the loss estimation methodology reports, on the first page, that there was not a significant variation in Ely & Company's loss estimates for liquidations versus mergers among the twenty-three insolvent thrifts resolved by FSLIC during early 1988. Given the extremely sick condition of many insolvent thrifts still in operation, I do not think we will see such as strong shift towards mergers as to materially alter Ely & Company's estimate of FSLIC's accumulated insolvency loss.

Garn question number 5. The estimates you have suggested are an average expectation of losses. What type of variance around this estimate is possible? That is, what is your best-case estimate and your worst-case estimate? What influences this variance?

Ely & Company's loss estimate for FSLIC tried, wherever possible, to err on the conservative side, i.e. to underestimate the size of FSLIC's accumulated insolvency loss. Thus, the best-case estimate would only be a few billion less than the $64 billion estimate while the worst-case estimate could easily be $20 billion higher. Two factors would have the greatest upward push on the loss estimate: (1) The amount of phantom interest income the insolvent thrifts are reporting as real income. Ely & Company does not attempt to estimate phantom interest income. (2) The median cost of funds for the industry would decline by less than twenty basis points once the FSLIC mess was resolved.

Garn question number 6. Of the panel of witnesses, you and Mr. Wolf had the widest divergence of estimates of the FSLIC problem. In view of this divergence, would you please comment on his results and methodology as compared to yours.

I am not privy to the loss estimation techniques that Mr. Wolf and the General Accounting Office have used to develop their estimate of FSLIC's accumulated insolvency loss. However, based on what I understand of GAO's techniques, I have several comments to offer:

(1) GAO relies far too heavily on GAAP accounting in estimating FSLIC's future losses. Unfortunately, GAAP has been badly abused in the thrift industry, most notably by the creation of goodwill when merging failing thrifts into supposedly stronger thrifts. The goodwill created in these transactions in reality is both a shift of what should be a FSLIC loss in these cases over to the equity capital of the acquiring thrift and then a deferral of that loss, with the amortization of that deferral spread over many years. This goodwill factor is not insignificant: In the last seven years, the amount of goodwill on the books of thrift institutions has risen from approximately $250 million to $25 billion, a hundred-fold increase. A substantial portion of this goodwill is carried as an asset by

thrifts Ely & Company has determined to be insolvent. Eliminating this goodwill as an asset significantly increases Ely & Company's estimate of FSLIC's accumulated insolvency loss.

(2) GAO does not appear to make any attempt to identify as yet unrecorded losses in asset values in insolvent or potentially insolvent thrifts. GAO's loss estimate would be understated by the amount of these unrecorded losses. Ely & Company's loss estimation technique attempts to identify these unrecorded losses on a thrift-by-thrift basis.

(3) Mr. Wolf indicated in his testimony that GAO's loss estimate relies in part on FSLIC's 10-year projection of funds available to it for case resolution. Since May 19, I have analyzed this projection, or at least the variations of it that Bank Board Chairman Danny Wall distributed when he testified to the Senate Banking Committee on May 26 and to the House Banking Committee on July 7 These forecasts are laced with very dubious assumptions. In my opinion, the GAO erred in placing any reliance on these forecasts in making, or tempering, its estimate of FSLIC's accumulated insolvency loss.

Chafee question. Is it your understanding that were FSLIC to run out of cash, that the next backstop source of funds is the insured thrifts themselves through a special 1%-of-deposits assessment?

It is my understanding that the Bank Board does have existing legislative authority to levy a special 1%-of-deposits assessment on the thrift industry for the purpose of increasing FSLIC's liquidity. Having the authority and using it are two different matters. In my opinion, it would be very unwise for the Bank Board to use this authority. The accounting profession almost surely, and very properly, would treat this assessment as an expense that would have to be charged against each thrift's net worth in the year in which the assessment was levied, less any tax offset by virtue of the deductibility of this expense.

A 1%-of-deposits assessment would at most put $9.5 billion in FSLIC's coffers. Approximately $2 billion of this would effectively represent a diversion of general tax revenues into FSLIC; the balance of $7.5 billion would come out of the net worth of the industry. However, the insolvency of already insolvent thrifts would be increased by $2.5 billion; therefore, FSLIC would not gain by an assessment on the insolvent thrifts. Thus, this maneuver really would only add a net of $7 billion to FSLIC's coffers. However, an after-tax charge of $5 billion against the net worths of presently solvent thrifts is bound to tip some of these thrifts into insolvency. Therefore, FSLIC's net gain actually would less than $7 billion; however, this gain would greatly weaken the industry unless it was traded off against a permanent suspension of the FSLIC special assessment.

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I hope my answers to these questions will be illuminating for you and the other members of the committee.

Very truly yours,

Bert Ely

Bert Ely

THE CALCULATION OF FSLIC'S ESTIMATED ACCUMULATED INSOLVENCY LOSS

Offered in support of testimony submitted to the
Senate Banking Committee on May 19, 1988

FSLIC's accumulated insolvency loss as of December 31, 1987, was estimated by Ely & Company to be $64 billion. This is the sum of the negative net worths of the 853 FSLIC-insured thrifts determined to be insolvent at the end of 1987. That is, the total liabilities of each of these 853 thrifts exceeded the estimated market value of each thrift's assets. Exhibit 2 illustrates the combined financial condition of these insolvent thrifts.

For the other 2,294 thrifts in operation at the end of 1987, the estimated market value of their assets exceeded their total liabilities.

The $64 billion loss estimate represents the present value of FSLIC's likely future loss, based on known economic conditions at the end of 1987. In effect, this calculation estimates that FSLIC would have had to write a $64 billion check at the end of 1987 to pay a third party to assume full liability for all of the 853 insolvent thrifts. While such an event could not have occurred, conceptually this is a realistic way to estimate FSLIC's accumulated loss at any given point in time.

The estimated market value of each thrift's assets is a simple average of two independently calculated asset values for each thrift: the "marked-down" value of its assets and the capitalized value of its gross interest income. Averaging the two values modifies extreme values that may occur under one of the valuation techniques.

Each valuation technique is described below. However, the exact figures used in each valuation formula have been treated as proprietary information. Each valuation technique was applied uniformly to all FSLIC-insured thrifts; no manual adjustments were made for any thrift. Due to this uniformity, the overall estimate of FSLIC's estimated insolvency loss is considered to be more precise than the likely estimate for any one thrift.

The valuation methodology does not distinguish between liquidations (insurance settlements) and assisted mergers. As the data in Exhibit 1 indicate, this valuation methodology provided fairly consistent results in underestimating FSLIC's costs of resolving those insolvent thrifts that it acted on during the first four months of 1988. Ely & Company's total estimated cost in the eleven insurance settlements was 88.5% of FSLIC's own cost estimate. In the twelve assisted mergers, Ely & Company's estimated cost was 83.8% of FSLIC's own cost estimate.

This valuation methodology excludes the value of tax loss carryforwards because tax savings arising out of FSLIC transactions merely reduce the revenues of the federal government; they have no effect on the total federal deficit. In effect, the realization of tax savings in FSLIC-assisted transactions reduces both the revenues and the expenses of the government by an equal amount.

The two valuation techniques do not explicitly account for future changes in prices, interest rates, or other economic variables. Instead, each technique relies on current market data, which reflects future expectations, to establish values as of a given date. Specifically, the valuation techniques rely on current interest rates, the cost of FSLIC's liquidations and assisted mergers, and the financial structure of sound thrifts as current indicators of future prices and values.

Marked-down value of assets

The mark-down valuation technique marks down, or reduces, the value of certain of a thrift's assets from book value to an estimated market value. In effect, this technique seeks to identify certain, but not necessarily all unrecorded losses in the value of the thrift's assets. The mark-down technique uses the asset structure of financially sound thrifts as the basis for determining the extent to which specific categories of assets in weak thrifts should be written down. Financially sound thrifts are those with a net worth under Generally Acceptable Accounting Principles (GAAP) of 3% or more at the end of 1987.

The following are the eight specific asset mark-downs taken against every thrift, where applicable.

1 - Additional loss reserve on non-mortgage loans. The loan loss reserve on non-mortgage loans was increased if accrued interest exceeded a reasonable level of gross non-mortgage loans and if the apparent loss reserve for these loans was inadequate. High levels of accrued interest are a strong indicator of nonperforming loans.

2 - Uncollectible accrued interest on mortgage loans. A portion of accrued interest on gross mortgage loans in excess of a reasonable amount was written off. The percentage of accrued interest written off was scaled upward as the amount of accrued interest increased relative to gross mortgage loans.

3 - The loan loss reserve for mortgage loans was increased if one of two factors indicated that the loan loss reserve was inadequate. These two factors were accrued interest as a percentage of gross mortgage loans and the gross amount of foreclosed real estate as a percentage of gross mortgage loans. The loan loss reserve was increased to the higher amount indicated by these two factors.

4 - The loss reserve for foreclosed assets was raised to equal a fixed portion of other repossessed assets plus a sliding scale for repossessed real estate.

5 - The valuation (loss) reserve for direct real estate investments was increased as direct real estate investments increased as a percentage of total GAAP assets. However, the amount of this increase was tempered by reported profits on real estate held for investment.

6 - Equity investments in service corporations were written down in a manner comparable to the way in which the valuation reserve for direct real estate investments was increased. Likewise, the amount of the write-down was tempered by reported service corporation profits.

7 - Excess fixed assets (office buildings, leasehold improvements, furniture and fixtures) were written down. The amount of this write-down was tempered by reported net income from office building operations.

8 - All goodwill was written off, less the estimated market value of mortgage servicing rights owned by the thrift.

One important asset adjustment was not made: the difference between the book value and the market value of mortgage-backed securities and other marketable investments. This adjustment was not made because the Bank Board does not collect the data with which to make this adjustment.

Capitalized value of gross interest income

The premise and technique for capitalizing the gross interest income stream of a thrift is as follows:

Premise. Investors should be willing to buy a pool of assets, such as the assets of a failed thrift, if they can earn an acceptable return on their equity capital through current income and capital appreciation. Thus, this valuation technique uses standard income capitalization techniques to estimate the approximate amount that an investor -- an individual, another thrift, or whoever -- would pay for the entire pool of assets based on the income generated by that pool even though very little is known about the individual assets in the pool.

Technique. The market value of all of a thrift's assets, except service corporation and direct real estate investments, was calculated by dividing the thrift's reported interest income from all sources by a capitalization factor, or discount rate. For example, if a thrift has total annual interest income of $10 million and its capitalization factor is 9%, then the market value of its total pool of assets would be $111.1 million. ($10 million divided by .09). The estimated market value of a thrift's equity in its service corporation and direct real estate investments was then added to the capitalized value of the thrift's gross interest income in order to arrive at the total value derived by this technique.

A capitalization factor was calculated for all 3,147 thrifts, starting with a base capitalization factor established for the entire thrift industry. The base capitalization factor used in these computations has three components:

(1) A cost of funds for all liabilities (including non-interest bearing liabilities) that is twenty basis points below the dollar-weighted median cost of funds during the second half of

1987 for those thrifts with positive GAAP net worths between 3% and 5%. This reduction in cost of funds below the current median assumes a massive resolution of FSLIC's problems will lower the cost of funds for healthy thrifts. It also assumes that the cost of funds for insolvent thrifts will be reduced to the level of the presently healthy thrifts once their negative net worths have been eliminated and their equity capital restored to at least 3%.

(2) A cost for the equity capital needed to capitalize a thrift at 3% of the value of its tangible assets.

(3) An overhead cost factor net of fee income, other income and other expense.

The base capitalization factor was algebraically adjusted for each thrift in the following manner:

(1) All income yield above the yield earned during the second half of 1987 by three-fifths of the thrifts (weighted as to asset size) with positive GAAP net worths between 3% and 5% was added to the base capitalization factor. This adjustment was used to account for risk taking that calls for a higher cost of funds on longer term deposits and debt and/or higher equity capital levels.

(2) The capitalization factor was reduced for thrifts with favorable funding costs relative to the median cost of funds for thrifts with 3% to 5% GAAP net worths. This adjustment reduces a thrift's capitalization factor. Above-average cost-of-funds percentages were ignored since Ely & Company assumes that new owners of a thrift's pool of assets would be able to fund the pool for no more than the median cost of funds of healthy thrifts.

(3) The capitalization factor also was adjusted to reflect deviations in balloon and adjustable-rate assets from the median for 3% to 5% GAAP net worth thrifts.

(4) The capitalization factor was reduced for thrifts with net overhead expense ratios below the dollar-weighted median for thrifts with GAAP net worths between 3% and 5%.

This capitalization technique is subject to these distortions:

(1) Interest income reported by thrifts can be overstated by the amount of interest accrued on loans where several years of interest were included in the loan amount and the loan later became non-performing or worse.

(2) The base capitalization factor assumes that cleansing the thrift industry of failing thrifts will enable the remaining thrifts to reduce their cost of funds by twenty basis points. This assumption materially increases the market value of the assets of the remaining thrifts.

(3) The base capitalization factor possibly understates the market value of thrifts generating substantial revenues from gains on the sale of assets and from other non-operating income. However, the amount of this understatement may not be significant given the cyclicality of these revenue sources, particularly when interest rates are rising as they have been recently.

The market value of the gross interest income stream for many thrifts is less than the marked-down value of their assets. This occurs in part because the Bank Board does not collect and disseminate data on the market value of thrift investments. However, the presence of investments suffering from market value losses often is detected by the income capitalization technique. The lower value of the interest income stream also reflects the fact that many thrifts, particularly the insolvent and marginal ones, are earning below-market returns on a substantial portion of their assets. Potential investors in these thrifts will respond accordingly.

Exhibit 1

A COMPARISON OF ELY & COMPANY'S FSLIC LOSS ESTIMATES with FSLIC'S REPORTED LOSSES IN 1988 CASE RESOLUTIONS

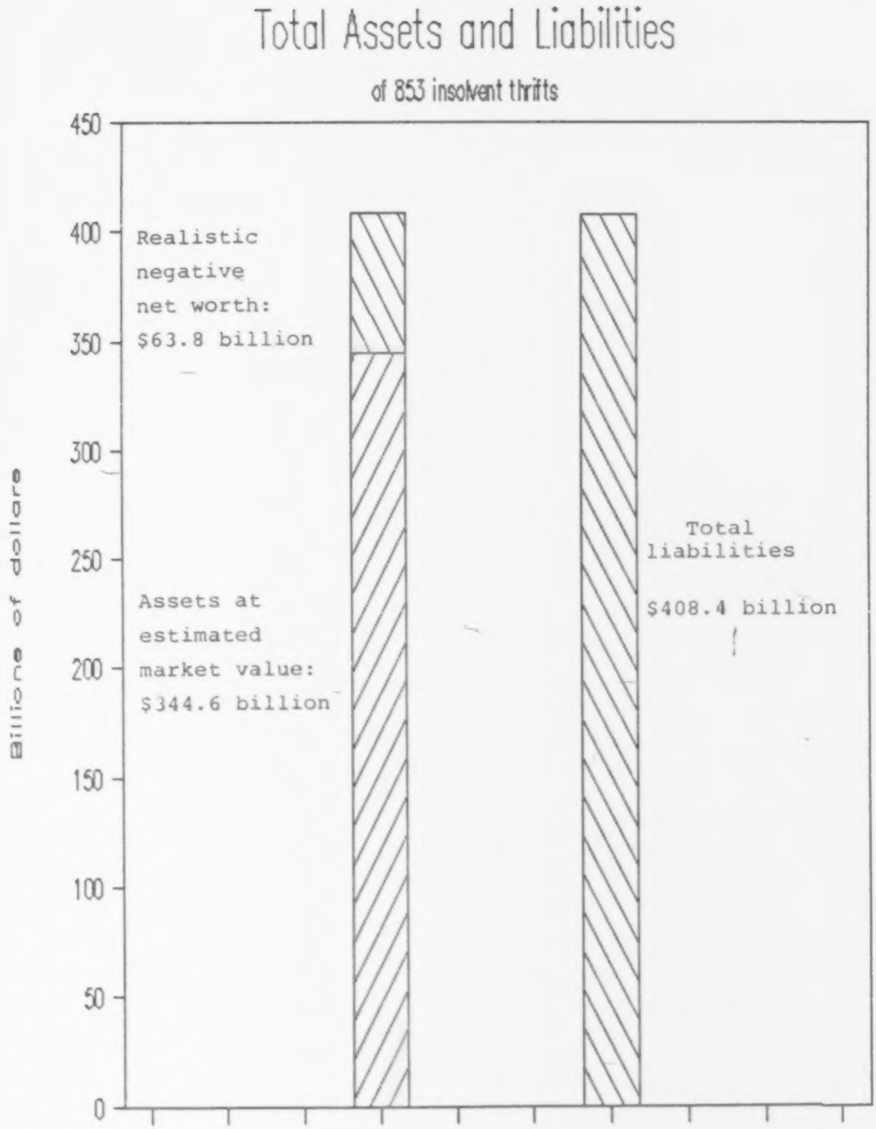
(dollars in millions)

FSLIC Insurance Settlements	Regulatory assets 12-31-87	FSLIC's estimated cost (1)	Ely's estimated loss
First Savings Association of East Texas, Houston, Texas	$ 61.7	$ 86.7	$ 97.2
Territory S&L, Seminole, Oklahoma	31.2	52.0	45.3
Citizens S&L, Salem, Oregon	139.3	135.0(2)	143.0
Mt. Whitney S&L, Exeter, California	33.7	46.4	49.8
Ramona Federal S&L, Fillmore, Calif.	44.7	76.3	82.7
First Federal S&L, Paducah, Kentucky	130.9	52.3	46.7
Investors S&L, El Reno, Oklahoma	80.6	(3)	51.6
United Savings S&L, Durant, Oklahoma	85.5	(3)	35.6
Totals for the two thrifts	166.1	76.3	87.2
First Federal S&L of Shawnee, Oklahoma	133.1	138.2	58.9
American Federal S&L, Anderson, Ind.	166.4	67.2	51.5
Cardinal Savings Bank, Newport, N.C.	89.7	34.4	14.5
FSLIC-assisted Acquisitions and Mergers			
First Federal S&L, Freeport, Illinois	30.4	14.0	12.4
Magnet Bank, F.S.B., Charleston, W. Va.	547.1	(3)	33.6
Traders Federal S&L, Parkersburg, W. Va.	71.5	(3)	7.1
Mountain States Federal S&L, Clarksburg, W. Va.	91.4	(3)	7.4
Totals for the three thrifts	710.0	81.5	48.1
First Federal S&L of Craig, Colorado	30.3	3.8	5.7
First Federated Savings Bank of North Palm Beach, Florida	142.7	(3)	61.8
Perpetual S&L, Waterloo, Iowa	118.9	(3)	5.8
First Federal Savings Bank, Waterloo, Ia.	152.4	(3)	73.2
Peoples Federal S&L, Waterloo, Iowa	152.4	(3)	3.2
Totals for the four thrifts	566.4	157.0	144.0
Tri-Cities S&L, Kennewick, Washington	54.5	15.8	16.1
Citizens S&L, East Alton, Illinois	39.0	6.1	7.1
Valley Federal S&L, Erwin, Tennessee	87.5	7.1	5.7
Totals	$2,514.9	$1,050.1	$915.9

Footnotes

(1) Cost data taken from Federal Home Loan Bank Board news releases.
(2) Cost inferred from the FHLBB news release.
(3) Cost data given only for the thrifts as a group.

Exhibit 2



As of December 31, 1987

Exhibit 3

ESTIMATED FSLIC INSOLVENCY LOSSES BY STATE

As of December 31, 1987

(dollars in millions)

	Estimated FSLIC loss	Total thrift assets in the state(1)
States with losses over $1 billion:		
Texas	$30,240	$ 100,077
California	9,380	346,985
Illinois	2,310	68,887
Florida	2,250	80,148
New York	1,610	55,778
Louisiana	1,580	15,694
Oklahoma	1,510	10,130
Arizona	1,240	24,097
Subtotals	50,120	701,796
Totals for ten states, each with estimated FSLIC losses between $500 million and $1 billion (2)	7,280	229,015
Rest of the United States	6,430	320,771
Totals	$63,830	$1,251,582

NOTES:

(1) Assets as defined under Regulatory Accounting Policies (RAP).

(2) The ten states are: Arkansas, Colorado, Kansas, Minnesota, New Jersey, New Mexico, Ohio, Oregon, Pennsylvania, and Utah.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM FREDERICK D. WOLF

Dear Mr. Chairman:

This letter responds to your June 7, 1988, inquiry seeking additional information related to our May 19, 1988, testimony on the financial condition of the Federal Savings and Loan Insurance Corporation (FSLIC). Specifically, you raised two questions on behalf of Senators Jake Garn and John H. Chafee. The questions and our responses follow.

Senator Garn's Question

"Of the panel of witnesses, you and Mr. Ely had the widest divergence of estimates of the FSLIC problem. In view of this divergence, would you please comment on his results and methodology as compared to your own."

In regard to the differences in the two estimates, it is important to understand that they were developed for different purposes. The estimates discussed in my testimony were developed in conjunction with our annual audit of FSLIC's financial statements and related to FSLIC's financial condition at December 31, 1987. These estimates were based upon the insured institutions that were insolvent as of December 31, 1987, as measured by generally accepted accounting principles (GAAP), and were for costs which would have been incurred for resolution actions taken at that time. These estimates were not meant to be a projection of the ultimate costs which may eventually be incurred to resolve the savings and loan industry's current and future problems. Conversely, Mr. Ely's estimate encompassed not only currently insolvent institutions, but also ones that Mr. Ely believes are technically insolvent because he believes their assets are worth less than recorded values. Accordingly, although Mr. Ely portrays the $64 billion as the cost as of December 31, 1987, his estimate does incorporate future failures.

Specifically, in regard to how the GAO estimates were developed, our total estimate of $26 to $36 billion was based upon a universe of 505 institutions that were GAAP insolvent at December 31, 1987. This estimate was comprised of two parts--$17.4 billion for approximately 200 insolvent institutions for which FSLIC had formally accepted responsibility for incurring the costs related to their resolution, and $9 to $19 billion for the 300 additional insolvent institutions. FSLIC estimated the $17.4 billion cost associated with its caseload using formal bids submitted by institutions seeking to acquire one or more failed thrifts, estimates by Federal Home Loan Bank supervisory staff, or calculations developed by FSLIC analysts. We audited this estimate and found it to be reasonable.

The costs related to the remaining 300 insolvent institutions were, for the most part, a greater unknown. These institutions have not been subject to as much scrutiny and study as have the FSLIC cases and, therefore, the amount and fact of loss were less definite. FSLIC believed that the best estimate of loss was the tangible net worth of these institutions, or $5.3 billion. We agreed that tangible net worth was a reasonable starting point, but we also considered historical cost factors in developing an estimate of the cost for this group. Using different historical cost ratios indicated a range of about $9 to $19 billion for the 300 additional insolvent thrifts. Accordingly, our estimate to resolve the problems of the 505 institutions that were insolvent at December 31, 1987, was $26 to $36 billion.

In contrast, Mr. Ely estimated the total industry resolution cost to be $64 billion, basing his estimate upon a much larger universe of institutions. To develop his $64 billion estimate, Mr. Ely calculated the expected market value of each institution's asset portfolio, basing it on the income generated from the assets. To calculate the revised net worth, Mr. Ely used an income capitalization technique in which he divided an institution's reported interest income by a capitalization factor, or discount rate, that had three basic components--a cost of funds for liabilities, a cost for equity capital, and an overhead cost factor. Mr. Ely then individually adjusted the base capitalization factor for the extent to which an institution (1) had an income yield above that earned by healthy institutions (increased the factor), (2) had favorable funding costs (decreased the factor), and (3) had adjustable-rate mortgages in its asset pool (decreased the factor). If the market value calculated in this manner was less than the book value of the institution's assets, the difference was considered to be due to non-performing assets that represented additional losses for the institution. Recognizing all such undisclosed losses decreased the institutions' net worth and resulted in a universe of 850 "insolvent" institutions. Therefore, Mr. Ely's estimated cost of resolving the thrift industry crisis was significantly higher than other estimates.

We would like to emphasize that the two estimates were made for different purposes. For this reason, the fact that the estimates differ does not necessarily mean that one of them is correct and the other is wrong. Moreover, as both Mr. Ely and I pointed out, a change in any one of numerous factors, including how quickly FSLIC resolves problem thrifts and whether FSLIC can attract sufficient investors, could adversely affect its resolution costs.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR CHAFEE FROM FREDERICK D. WOLF

Senator Chafee's Question

"Is it your understanding that were FSLIC to run out of cash, that the next backstop source of finds is the insured thrifts themselves through a special 1%-of-deposits assessment?"

As we noted in our May 19, 1988, testimony, FSLIC has a variety of backstop sources of funds available. Under 12 U.S.C. 1727(i), FSLIC may require insured institutions to deposit a special 1 percent-of-deposits assessment into FSLIC, while other statutes authorize FSLIC to borrow funds from various sources. None of the statutes governing the funding sources available to FSLIC expressly require FSLIC to establish a priority in the use of those funding sources or to exhaust one funding source before availing itself of another.

In regard to the special 1 percent-of-deposit assessment, several items are worth noting. First, notwithstanding the absence of a statute prioritizing the use of FSLIC's funding sources, FSLIC's use of the 1 percent-of-deposits assessment as the next backstop source of funds would continue the practice of using the savings and loan industry to provide funding for FSLIC before resorting to outside sources. In addition to the $10.8 billion in funds it is authorized to raise under the Competitive Equality Banking Act of 1987, FSLIC currently funds its operations through a 1/12 of 1 percent of insured deposits regular assessment (12 U.S.C. 1727(b)(1)) and through a special assessment of 1/8 of 1 percent of insured deposits (12 U.S.C. 1727(c)(1)).

Second, while FSLIC could raise almost $10 billion through the 1 percent assessment, it is important to consider the effect this assessment would have on the industry and FSLIC. Depositing 1 percent of deposits into FSLIC would adversely affect many S&Ls, particularly those that are insolvent or barely solvent. Also, since this 1 percent-of-deposits assessment is a "deposit" into FSLIC, receiving these funds would not reduce FSLIC's $13.7 billion deficit. Instead, FSLIC would have a substantial liability on which it would have to pay interest, and which would apparently have to be repaid at some point in the future.

We hope that we have been responsive to your request. If we can be of any more assistance, please call me or Mr. Robert W. Gramling, Associate Director, at 275-9461.

Sincerely yours,

Frederick D. Wolf
Director

Federal Home Loan Bank Board

1700 G Street, N.W.
Washington, D.C. 20552

Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

02 SEP 1988

The Honorable William Proxmire
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510-6075

Dear Mr. Chairman:

Enclosed are the Federal Home Loan Bank Board's responses to the follow-up questions raised with regard to the May 26, 1988 hearing before your Committee concerning the Condition of the Thrift Industry. As you will recall, by letter dated July 7, 1988, we responded to the questions concerning the acquisition of First Federal Savings Bank of West Palm Beach, Florida. The enclosed are answers to the remainder of the questions. In addition, we are providing our answers to a question that was asked during the hearing by Senator Riegle. I hope these answers will be helpful.

Sincerely,

M. Danny Wall
Chairman

RESPONSE TO QUESTION OF SENATOR RIEGLE BY M. DANNY WALL

Question from Hearing

Transcript at page 75.

Q. Senator Riegle -- With respect to FADA's disposition of assets from the beginning up to the present time, if you were to take a rough gauge of the book value of assets that get folded in and then what they were able to dispose of taking it all together, what are they getting in terms of the disposition value as against original asset value? Are they getting 50 cents on the dollar, 10 cents on the dollar, 90 cents on the dollar? What's been the running bottom line for FADA?

A. Sales proceeds as a percent of the net takeover value from the inception of FADA through March 31, 1988 is sixty-five percent. This figure is for sales only and does not include restructures, cash settlements or payoffs.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE FROM M. DANNY WALL

Follow-up questions from Senator Proxmire

Q.1. The Southwest plan is the corner stone of the Bank Board's remedial strategy. The plan includes guarantees to a surviving institution of the quality of assets and earnings. Could you please describe the nature and extent of these guarantees.

A.1. The FSLIC assistance provided in connection with the Southwest Plan has consisted of 1) FSLIC notes equal to the negative net worth of the institutions and 2) yield maintenance and capital loss coverage on certain assets acquired from the troubled institutions. Yield maintenance is a promise by the FSLIC to pay a portion of the interest payable on problem or nonearning assets. Capital loss coverage is a partial reimbursement by FSLIC for the capital loss suffered by an institution when a bad asset is sold. In the five Southwest plan deals consummated to date, the Bank Board issued five 10-year notes totaling approximately $3.5 billion. In these deals, we provided yield maintenance at varying rates over the cost of funds in Texas. Coverage for capital losses on assets was tailored to each deal: in some cases all problem assets except loans on 1-4 family residences and furniture, fixtures and equipment and office buildings were covered; in others, certain securities and assets specific to the institution were also excluded.

Q.2. There are currently 259 insolvent thrifts in FSLIC's caseload. The Bank Board anticipates that it will ultimately spend $17.4 billion to resolve them. How many failed thrifts will be resolved this year? How many thrifts will there be in the caseload at the end of the year?

A.2. As of December 31, 1987, there were 259 insolvent thrifts in FSLIC's caseload. By September 30, 1988, fiscal year-end, the FSLIC anticipates it will resolve 142 of these thrifts. Because of the possibility that some projected case resolutions may not occur as planned and that the timing of incoming cases is difficult to determine, it is very difficult to predict the number of insolvent thrifts in FSLIC's year end caseload. However, if you assume that FSLIC meets its goal of 142 resolutions, FSLIC's 1988 fiscal year end caseload will consist of 117. This assumes that there will be no additional institutions that become insolvent during fiscal year 1988. If however, we assume the caseload will be the same as the 1987 increase (76 new cases), FSLIC's fiscal year end caseload would total 193 institutions. We believe that the number of new cases will fall somewhere within the range of 0 to 76.

Q.3. Mr. Frederick Wolf of GAO in his testimony on May 17, 1988 warned that in its rescue package FSLIC cannot issue notes instead of cash indefinitely. Issuing too many notes would detract from their creditability and cause their value to be discounted. How many notes does the FSLIC plan to issue this year? How many does it plan to issue over the next 5 years.

A.3. Based on the mid-session review of the Office of Management and Budget, FSLIC estimates that it will issue the following amount of notes during 1988 and the five year period following:

FY1988	FY89	FY90	FY91	FY92	FY93
$5.8B	$4.6B	$1.7B	$1.99B	$1.89B	$.34B

During this period, FSLIC plans to make payment on (retire) a total of $3.35 billion of notes payable. The projected balance of outstanding notes payable at the end of FY 1993 is $15.7 billion.

Q.4. Risk-based arbitrage is a potentially risky strategy being increasingly adopted by venturesome S&Ls. How is the Bank Board examining and supervising this activity?

A.4. Risk-based arbitrage (also known as risk-controlled arbitrage (RCA) or structured asset/liability transactions (SALT)) is a repackaging of traditional thrift activities. Typically, mortgage-backed securities (MBS) are purchased with short-term liabilities, usually reverse repurchase agreements, and then hedged to maintain a desired interest rate spread over a wide range of interest rates. Properly conceived, implemented and managed, this activity can be extremely profitable for thrift institutions and is consistent with safe and sound practices.

This strategy is risky if it is improperly implemented such as leaving the interest rate mismatch between the short-term liabilities and the long-term assets unhedged or if the thrift institution does not possess sufficient technical expertise and internal controls to understand and monitor the strategy effectively.

The Bank Board provides training and guidance to its examination and supervisory staff on these activities so that the staff can determine if RCA programs conducted by S&Ls are being effectively implemented and monitored. The Office of Regulatory Affairs issued a detailed Supervisory Procedures Memorandum (SP-74) titled "Risk Controlled Arbitrage" on February 16, 1988 that defines RCA, outlines the risks of this financial strategy and provides examiners and supervisory agents with model financial analyses and internal controls guidelines to help them evaluate whether an institution can manage this type of complex strategy.

The Bank system Office of Education offers a three-day Risk-Controlled Arbitrage course several times a year to Bank System personnel. This course significantly increases the sophistication of examiners and supervisory personnel on these matters by providing a thorough analysis of the financial instruments used in RCA and the appropriate methods of constructing and rebalancing an RCA. The course also includes a discussion of accounting issues and appropriate examination and supervisory procedures for RCA.

Future measures to increase examination and supervision expertise on RCA include publishing guidelines on derivative mortgage products, the designation of capital markets "experts" at each individual District Bank as an information resource for examiners and the development of a Regulatory Handbook with detailed evaluative criteria for use by examiners to determine if an institution has sufficient expertise and internal controls to manage this activity. The Board will require that thrift institutions "unwind" their RCA transactions if they cannot demonstrate their ability to effectively implement and control the strategy.

Q.5. The Bank Board is increasingly being criticized for making "thin deals" in its bailout packages. The deals announced so far in the Southwest plan do not introduce enough new capital from outside investors to bring the surviving thrifts to a well-capitalized level. Are you not concerned that the Southwest plan is just another exercise in forbearance that allows poorly capitalized thrifts to continue operating? How will you prevent these under-capitalized thrifts from gambling and losing at the FSLIC's expense as the earlier insolvent cohorts did?

A.5. Attracting new capital to the industry is certainly one important facet of the Southwest plan. Any potential solutions which bring outside capital are given high priority. To that end, the recent Southwest Plan acquisition by Merabank involved the contribution by Merabank of $8.8 million equivalent to 3% GAAP capital. Merabank Texas, FSB will have total RAP capital of 5%. The two other transactions completed, thus far, were based on the best proposals that FSLIC received for those particular groups of thrifts. Among other benefits, these particular transactions brought management teams capable of providing the leadership and controls necessary to achieve viability.

The Southwest Plan is certainly not an exercise to provide capital forbearance to poorly capitalized thrifts. The institutions in the Southwest Plan are not poorly capitalized; they are insolvent. Consolidation of these insolvent institutions will result in some very real benefits including:

- Significant savings in operating expenses;
- Management teams capable of providing the leadership and controls necessary to achieve viability, and;
- The ability to permit higher cost deposits to be reduced by cash flow from investments supported by lower cost deposits.

In addition to the regular exam process, FSLIC will be monitoring the consolidated thrifts very closely in connection with its assisted agreement.

Q.6. On May 19, 1988 a panel of thrift experts testified before this Committee. They estimated the costs of S&L industry clean-up to be between $26 and $64 billion and growing rapidly the longer we delay. In your testimony you estimated that $22.7 billion might be needed to resolve industry problems? Why are you more optimistic than the panel? How quickly are the problem and the cost of its resolution growing?

A.6. As you are aware, in July the Bank Board revised its estimate of the cost of resolving thrifts in Texas based on our experience with the Southwest plan deals we have processed thus far. This revision is an increase of $8.2 billion from the earlier estimate of $7 billion, bringing our estimate of resolving thrifts in the state of Texas to $15.2 billion. As a result, our overall cost estimate for resolving industry problems now stands at $30.9 billion.

The Bank Board's calculation of the "size of the problem" is based on the estimated cost to resolve the problems of those insolvent institutions for which the FSLIC has assumed responsibility plus a projection of an additional amount attributable to cases that may be assigned to FSLIC in the future. It assumes a deposit growth of 1.75 percent per quarter; continued tax exempt treatment of FSLIC assistance; and the continuation of the special assessment. The General Accounting Office has said that our assumptions are relatively optimistic but not unrealistic. Since we cannot predict with certainty future interest rates, oil prices, real estate values and the like, the size of the problem cannot be predicted with certainty. Therefore, a better way to interpret our prediction is to consider it an identification and allocation of resources available to resolve cases and not an estimate of the size of the problem.We will, of course continue to update our estimates as new data becomes available.

Q.7. Deals in the Southwest plan involve the consolidation of several weak or failing S&Ls. Consolidation forces the surviving institution to grow fast. Yet growth is known to put enormous strain on an institution and it is a good predictor of failure even for well-capitalized thrifts. How do you reconcile the policy of consolidation with the Bank Board's anti-growth stance?

A.7. Consolidation forces the surviving entity to grow only to the extent of the acquired assets. Consolidation does not demand or encourage the type of growth that was responsible for the failure of a segment of the industry. Rather the type of consolidation mandated by the Southwest Plan will reduce the number of savings and loans and deposit-gathering offices; should provide immediate operational savings through economies of scale; and should reduce the cost of funds to insured institutions in the ninth district. Consolidation of this type is not inconsistent with Bank Board policy.

RESPONSE TO WRITTEN QUESTIONS OF SENATORS PROXMIRE AND GRAHAM FROM M. DANNY WALL

Q. As we have discussed, there is a built-in conflict between your role as protector of the insurance fund and the taxpayers and your role as Chairman of the Bank Board promoting the savings and loan industry. As early as 1945 the GAO questioned the desirability of permitting an agency having the authority to promote and charter federal savings and loan associations, which are required by law to be insured, to also administer the insurance underwriting. The GAO has stated that experience has shown that those functions are inherently conflicting and has recommended that the Congress consider separating the FSLIC from the FHLBB.

Please provide your recommendations on behalf of the Board with respect to the desirability of separating these functions.

A. The combination of the insurance of the thrift industry through the FSLIC with the regulation and supervision of insured institutions in one agency necessarily involves some conflicting interests. However, we believe that this approach is preferable to the separation of these functions. The specialized nature of the thrift industry requires that the insurance function be closely tailored to the industry by regulators with a deep understanding of its needs. Moreover, the competing interests that sometimes arise can, in fact, operate as checks on both the regulatory/supervisory function as well as the insurance function. I would note that although the GAO advocated a separation of these functions 45 years ago, the 1984 Blueprint For Reform published as a result of the Bush Task Force study of the regulation of financial services recommended that the two functions remain under the control of the Federal Home Loan Bank Board. (Page 67).

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM
M. DANNY WALL

Q.1. Do you think it is appropriate for people to put their funds in an insured institution and then have the institution turn around and invest those funds in high-yielding junk bonds?

A.1. In Section 5(c) of the Home Owners' Loan Act ("HOLA") Congress has established the investments that are permissible for federal associations. 12 U.S.C. § 1464(c) (1982 & Supp. IV 1986). Authorized investments include commercial loans: a federal association may invest up to 10 percent of its assets in "secured or unsecured" commercial loans. 12 U.S.C. § 1464(c)(1)(R). In turn, commercial loans include high-yield, below investment grade debt securities, or so-called "junk bonds." See 12 C.F.R. § 545.46 (1988); 48 Fed. Reg. 12,045 (May 23, 1983). In addition, the Board's regulations provide that, notwithstanding any rating or marketability limitations, a federal association may invest up to one percent of its assets in commercial paper and corporate debt securities if, "in the exercise of its prudent business judgment" it finds sufficient evidence that the obligor on the instrument will be able to perform its obligations. 12 C.F.R. § 545.75(a) (1988). Thus, under the provisions cited, a federal association is currently permitted to invest in junk bonds in an amount that may not exceed 11 percent of its assets.

The Bank Board is, of course, aware that a federal association's investment in junk bonds may, under some circumstances, present greater risk to the investing association than other, more traditional investments. Mindful of the potential for enhanced risk, the Board's Office of Regulatory Affairs (formerly, the Office of Regulatory Policy, Oversight and Supervision) has recently issued a supervisory memorandum setting forth guidelines to ensure safe and sound investment in commercial loans, including junk bonds. ORA Memorandum No. R-63a (June 14, 1988). A copy of this R Memorandum is attached to our submission. Moreover, investment in junk bonds is the subject of ongoing analysis by Board staff so that it can recommend, within the applicable statutory framework, modifications of regulatory policy as necessary and appropriate.

The question whether thrift institutions ought to be able to use insured deposits to find junk bond investments is, as the Congress has recognized, an issue of policy involving all financial institutions, not only those regulated by the Bank Board. We note that the Competitive Equality Banking Act of 1987 ("CEBA") directed the Comptroller General, in consultation with other interested agencies of the federal government, including the Bank Board and the FSLIC, to do a comparative study of junk bond investments. CEBA § 1201, 101 Stat. 522, 660 (1987). The results of that study will be carefully considered by the Board and its staff in assessing the advisability of further regulatory action; they may also provide the basis for further action on the part of the Congress.

Finally, the limitations on investment authority described above apply only to federally chartered thrift institutions. The investment powers of state-chartered, FSLIC-insured thrifts are governed by the laws of the appropriate state. Thus, state-chartered institutions may be able to engage in junk bond investment activity to a greater extent than their federally chartered counterparts.

Q.2. Section 104(f) of the Competitive Equality Banking Act provides that a savings bank insured by the FDIC may elect to be treated as a FSLIC insured thrift institution for purposes of the Savings and Loan Holding Company Act, so long as the savings bank meets the qualified thrift lender test. In essence, this provision would allow a FSLIC insured institution to convert to FDIC insurance, and still retain the benefits of being part of a savings and loan holding company. Do you believe that this provision will encourage FSLIC insured institutions to leave the system? Would you recommend that it be changed?

A.2. In the Congressional debate last year on the issue of whether thrift institutions leaving the FSLIC insurance system should be required to pay some sort of exit premium, and if so how much, one of the principal arguments made against increasing the exit fee beyond the so-called "two-plus-two" amount ultimately selected was that only a few FSLIC-insured institutions would convert to FDIC-insured banks because of the many disincentives that existed that would discourage, if not prevent, such thrifts from changing insurers. Two of the major disincentives that were noted were the higher capital requirements and more limited holding company activities that exist for bank holding companies. See, e.g., 133 Cong. Rec. H 3168, daily ed. May 5, 1987 (remarks of Cong. Barnard).[1] To the extent that the election provisions of section 104(f) remove these disincentives by allowing the parent company of the converting thrift to continue to be regulated as a savings and loan holding company, the statute clearly facilitates, if not encourages, the conversion of FSLIC-insured thrifts into FDIC-insured savings banks. In this regard, the Bank Board notes that to date most of the grandfathered insured institutions that have converted or are converting into FDIC-insured savings banks have applied to be deemed "insured institutions" pursuant to section 104(f) in order to enable their parent companies to retain the benefits of regulation as savings and loan holding companies.

The Bank Board has no objection to enabling thrift holding companies that own institutions originally chartered as FDIC-insured savings banks to elect to be regulated as savings and loan holding companies (rather than as bank holding companies), provided that their subsidiary thrifts meet the QTL test set forth in section 104(c). However, in view of the fact that section 104(f) makes it much more attractive for an FSLIC-insured thrift to convert into an FDIC-insured savings bank at a time when, as the Congress recognizes, it is critical to preserve the premium base of the FSLIC insurance fund, the Bank Board would recommend that FSLIC-insured institutions that convert to FDIC insurance be excluded from the class of thrift institutions that are eligible to be deemed "insured institutions" under the statute, and that, accordingly, the parent companies of such institutions be required to register as bank holding companies subject to the provisions of the Bank Holding Company Act and the regulations thereunder.

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[1] Two of the other disincentives mentioned were loss of the ability to borrow on favorable terms from the Federal Home Loan Banks and payments of prepayment fees in connection with the liquidation of that would be required upon conversion. Id.